DOCKET

No. 08-586
Title: Jerry N. Jones, et al., Petitioners
v.
Harris Associates L.P.
Docketed: November 3, 2008
Lower Ct: United States Court of Appeals for the Seventh Circuit
Case Nos.: (07-1624)
Decision Date: May 19, 2008
Rehearing Denied: August 8, 2008
Questions Presented

Date	Proceedings and Orders
Nov 3 2008	Petition for a writ of certiorari filed. (Response due December 3, 2008)
Nov 6 2008	Consent to the filing of amicus briefs, in support of either party or neither party, received from counsel for the petitioners.
Dec 2 2008	Order extending time to file response to petition to and including January 5, 2009.
Dec 3 2008	Brief amici curiae of Law Professors filed.
Dec 3 2008	Brief amici curiae of AARP, and Consumer Federation of America filed.
Dec 31 2008	Order further extending time to file response to petition to and including February 2, 2009.
Feb 2 2009	Brief of respondent Harris Associates L.P. in opposition filed.
Feb 18 2009	DISTRIBUTED for Conference of March 6, 2009.
Feb 18 2009	Reply of petitioners Jerry N. Jones, et al. filed. (Distributed)
Mar 9 2009	Petition GRANTED.
Apr 21 2009	The time within which to file the joint appendix and petitioners' brief on the merits is extended to and including June 10, 2009.
May 6 2009	The time within which to file respondent's brief on the merits is extended to and including August 27, 2009.
May 22 2009	Consent to the filing of amicus curiae briefs in support of either party or neither party received from counsel for the petitioners.
Jun 10 2009	Joint appendix filed (two volumes). Statement of costs received.
Jun 10 2009	Brief of petitioners Jerry N. Jones, Mary F. Jones, and Arline Winerman filed.
Jun 15 2009	Brief amici curiae of Law Professors filed.
Jun 15 2009	Brief amicus curiae of John C. Bogle filed.
Jun 15 2009	Brief amici curiae of AARP, and Consumer Federation of America filed.
Jun 15 2009	Brief amicus curiae of United States filed.
Jun 17 2009	Brief amicus curiae of National Association of Shareholder and Consumer Attorneys filed.
Jun 17 2009	Brief amicus curiae of North American Securities Administrators Association filed.
Jun 17 2009	Brief amici curiae of Professor Deborah A. DeMott and Professor Mark L. Ascher filed.
Jun 17 2009	Brief amici curiae of Robert Litan, Robert Mason, and Ian Ayres filed.
Aug 17 2009	SET FOR ARGUMENT ON Monday, November 2, 2009.
Aug 17 2009	CIRCULATED.
Aug 18 2009	Record for the U.S.C.A. for 7th Circuit. (Entire record e-mailed in PDF format)

Aug 25 2009	Record received from U.S.D.C. for the Northen District of Illinois. (1 box)
Aug 27 2009	Brief amicus curiae of Securities Industry and Financial Markets Association filed. (Distributed)
Aug 27 2009	Brief of respondent Harris Associates L.P. filed. (Distributed)
Aug 31 2009	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument filed.
Sep 3 2009	Brief amicus curiae of Independent Directors Council filed. (Distributed).
Sep 3 2009	Brief amicus curiae of Investment Company Institute filed. (Distributed)
Sep 3 2009	Brief amicus curiae of Chamber of Commerce of the United States of America filed. (Distributed).
Sep 3 2009	Brief amici curiae of Law and Finance Professors and Scholars filed. (Distributed)
Sep 3 2009	Brief amicus curiae of Fidelity Management & Research Company filed. (Distributed)
Sep 3 2009	Brief amicus curiae of Mutual Fund Directors Forum filed. (Distributed)
Sep 3 2009	Brief amicus curiae of Cato Institute filed. (Distributed)
Sep 22 2009	Letter received from counsel for the respondent.
Sep 28 2009	Reply of petitioner Jerry N. Jones, et al. filed. (Distributed)
Oct 5 2009	Motion of the Solicitor General for leave to participate in oral argument as amicus curiae and for divided argument GRANTED.
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PETITION FOR WRIT OF CERTIORARI

Supreme Court, U.S.
FILED

08-586 NOV 3 - 2008

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No. —

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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QUESTION PRESENTED

Congress enacted the Investment Company Act of 1940 to mitigate the conflicts of interest inherent in the relationship between investment advisers and the mutual funds they create and manage. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984). Section 36(b) of that Act imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services" and authorizes fund shareholders to bring a claim for "breach of [that] fiduciary duty." 15 U.S.C. § 80a-35(b). The Act further provides that, in such an action, "approval by the board of directors" of the fund is not conclusive, but "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.* § 80a-35(b)(2). The question presented is:

Whether the court below erroneously held, in conflict with the decisions of three other circuits, that a shareholder's claim that the fund's investment adviser charged an excessive fee – more than twice the fee it charged to funds with which it was not affiliated – is not cognizable under § 36(b), unless the shareholder can show that the adviser misled the fund's directors who approved the fee.

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Jerry N. Jones, Mary F. Jones, and Arline Winerman respectfully petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

INTRODUCTION

The Seventh Circuit in this case expressly rejected the Second Circuit's standard, which the Third and Fourth Circuits follow, for assessing a claim that a mutual fund's investment adviser – a statutory fiduciary under the Investment Company Act of 1940 ("ICA" or "Act") – charged an excessive fee for investment-advisory services. The judges of the Seventh Circuit divided evenly (five-to-five, with one judge recused) on whether to rehear the panel's decision en banc. As Judge Posner explained in dissenting from the denial of rehearing en banc, "the creation of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel's analysis" warrant further review. Pet. App. 42a-43a.

Mutual funds ordinarily are formed and run by their investment advisers. Because of the symbiotic relationship between advisers and their funds, "the forces of arm's-length bargaining" over compensation "do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." S. Rep. No. 91-184, at 5 (1969). In response to "the potential for abuse inherent in [that] structure," Congress enacted the ICA. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (internal quotation marks omitted). After several decades of practice under the ICA, Congress concluded that investment advisers continued to charge their funds excessive fees for investment-advisory services, despite the structural safeguards the original ICA imposed.

In 1970, to combat the persistent problem of excessive investment-adviser fees, Congress added § 36(b) to the ICA. Section 36(b) imposes on investment advisers "a fiduciary duty *with respect to the receipt of compensation for services*" and authorizes fund shareholders to bring a claim for "breach of [that] fiduciary duty." 15 U.S.C. § 80a-35(b) (emphasis added). In the leading case interpreting § 36(b), the Second Circuit held that an investment adviser breaches its fiduciary duty with respect to compensation when it charges "a fee that is so disproportionately large" that, in light of all pertinent facts, the fee "bears no reasonable relationship to the services rendered." *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982). Courts in the Second Circuit have applied that standard for more than 25 years. And the Third and Fourth Circuits have followed the Second Circuit's lead in adopting the *Gartenberg* standard.

In the decision below, the Seventh Circuit expressly rejected the prevailing interpretation of § 36(b) and "disapprove[d] the *Gartenberg* approach." Pet. App. 8a. Instead, the court held that an allegation that an adviser charged excessive fees for advisory services does not state a claim for breach of fiduciary duty under § 36(b), unless the adviser also misled the fund's board of directors in obtaining their approval of the compensation. *See id.* at 8a-9a. The court adopted that standard even though the ICA expressly provides that, in § 36(b) cases, approval of the fee by the fund's board is not conclusive, but "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). The panel also gave no weight to powerful – and undisputed – evidence that the fee

charged in this case would not have been agreed to in an arm's-length negotiation: the fee was more than twice what the investment adviser charges to clients it does not control. *See* Pet. App. 6a; *see also id.* at 39a (Posner, J.).

The proper interpretation of § 36(b) presents a question of surpassing importance to the 44 percent of American families with $11.5 trillion in retirement and personal savings invested in mutual funds.[1] This Court's immediate review therefore is warranted to resolve the square conflict in the circuits on whether an investment adviser's fiduciary duty "with respect to the receipt of compensation" under § 36(b) in fact encompasses the amount of compensation that the adviser may charge a fund it controls and is not limited to cases where the board has been misled.

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 527 F.3d 627. The opinion of the district court (Pet. App. 15a-33a) is not reported but is available at 2007 WL 627640.

JURISDICTION

The court of appeals entered its judgment on May 19, 2008, and denied a petition for rehearing on August 8, 2008. *See* Pet. App. 34a-43a. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

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[1] *See* Investment Company Institute, *Trends in Ownership of Mutual Funds in the United States, 2007*, at 1 (Nov. 2007) ("*2007 Trends in Ownership*"), *available at* http://www.ici.org/pdf/fm-v16n5.pdf; Investment Company Institute, *Trends in Mutual Fund Investing, August 2008* (Sept. 29, 2008) ("*Trends in Mutual Fund Investing*"), *available at* http://www.ici.org/stats/latest/trends_08_08.html#TopOfPage.

STATUTORY PROVISIONS INVOLVED

Relevant provisions of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, are reproduced at Pet. App. 44a-64a.

STATEMENT

A. Statutory and Regulatory Background

1. Mutual funds are "typically created and managed by a pre-existing external organization known as an investment adviser." *Daily Income Fund*, 464 U.S. at 536 (citing *Burks v. Lasker*, 441 U.S. 471, 481 (1979)). The relationship between a fund and its adviser "is fraught with potential conflicts of interest," because the adviser "generally supervises the daily operation of the fund and often selects affiliated persons to serve on the company's board of directors." *Id.* (internal quotation marks omitted). To mitigate such conflicts of interest, Congress enacted the ICA in 1940 and imposed a number of structural safeguards on the industry. *See id.* at 536-37.

Following the Act's passage, investment advisers continued to exploit their control over mutual funds to charge excessive fees. One study concluded that "investment advisers often charged mutual funds higher fees than those charged the advisers' other clients and further determined that the structure of the industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation." *Id.* at 537. A subsequent Securities and Exchange Commission ("SEC") investigation found that "investment advisers were generally compensated on the basis of a fixed percentage of the fund's assets, rather than on services rendered or actual expenses," and that, "as a fund's assets grew, this form of payment could produce unreasonable

fees in light of the economies of scale realized in managing a larger portfolio." *Id.*

The SEC also had concluded that "lawsuits by security holders challenging the reasonableness of adviser fees had been largely ineffective due to the standards employed by courts to judge the fees." *Id.* Courts applied either state common-law standards of corporate waste – under which fees could be challenged only if they were "unconscionable" or "shocking" – or, under the ICA, a standard requiring shareholders to prove "gross abuse of trust." *Id.* at 540 & n.12. As a consequence, courts often relied on director approval of fees to deny relief. *See id.*

2. To combat the continuing problem of excessive investment-adviser fees, Congress enacted the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413 ("1970 Amendments"). *See Daily Income Fund*, 464 U.S. at 537-39. The 1970 Amendments strengthened the ICA's structural protections by requiring that at least 40 percent of a fund's directors be persons who are not "interested" in the adviser. 15 U.S.C. § 80a-10(a); *id.* § 80a-2(a)(19)(A)(iii). The Act as amended also requires that a majority of the "noninterested" directors annually approve the adviser's compensation agreement, "at a meeting called for the purpose of voting on such approval." *Id.* § 80a-15(c).

Recognizing that the existence of procedural safeguards had not eliminated excessive adviser fees, Congress also enacted a substantive protection against undue compensation by adding § 36(b) to the ICA. *See Daily Income Fund*, 464 U.S. at 539-40. Section 36(b) imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). It also grants

shareholders a private right of action. *Id.* Congress further specified that, in a shareholder suit under § 36(b), director approval of the adviser's compensation would not be conclusive, but rather "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.* § 80a-35(b)(2).

B. Facts

Petitioners own shares in several mutual funds – referred to as the "Oakmark funds" – for which respondent Harris Associates serves as the investment adviser. *See* Pet. App. 1a. Harris created the funds, manages the funds' daily operations, and even provides the funds' office space and equipment. *See id.* at 39a-40a. In addition, Harris selected each of the members of the funds' board of trustees. The Oakmark funds are thus typical "controlled" or "captive" mutual funds – exactly the type of fund that Congress sought to protect through the ICA. *Id.*

Harris charges the Oakmark funds fees for investment-advisory services that are based on a percentage of each fund's net assets. Those fees are more than twice what Harris charges independent funds that it advises. For example, during the relevant period, Harris charged one of the Oakmark funds one percent of the first $2 billion of the fund's assets. For institutional clients (such as pension funds) that Harris advises but does not control, Harris charged roughly one-half of one percent for the first $500 million in assets and roughly one-third of one percent for everything above. *See id.* at 6a, 17a, 39a.[2]

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[2] Specifically, Harris charged a comparable institutional client 0.75 percent of the first $15 million under management,

In addition to charging fees far exceeding those it billed to independent clients, Harris accepted compensation in violation of a number of the ICA's structural safeguards, which Congress designed to check adviser fees. For example, although Victor Morgenstern – the chair of the board and one of the funds' supposedly disinterested trustees – was a former Harris partner with a continuing financial interest in Harris worth hundreds of thousands of dollars per year, Morgenstern participated in the statutorily mandated disinterested-trustee meetings at which Harris's fee agreements were reviewed and approved. *See* 15 U.S.C. § 80a-15(c); Pet. App. 2a-3a; C.A. App. A78-A80, A87.[3] Further, the funds' registration statements did not disclose Morgenstern's financial interest in Harris, as the Act requires. *See* 15 U.S.C. § 80a-33(b); Pet. App. 3a; C.A. App. A88.

C. Proceedings Below

1. In August 2004, petitioners sued Harris in federal district court, alleging that Harris breached its fiduciary duty with respect to compensation under § 36(b) of the ICA. Petitioners asserted that Harris charged the Oakmark funds excessive investment-advisory fees, in violation of § 36(b). They also contended that Harris breached its fiduciary duty under § 36(b) by accepting fees in violation of the Act's structural protections against undue compensation – namely, the provisions requiring approval of fee agreements by disinterested directors and disclosure of conflicts.

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with the percentage decreasing thereafter. *See* Pet. App. 6a, 17a.

[3] *See also* Pet. App. 18a (describing other financial and personal relationships between the funds' directors and Harris).

Harris moved for summary judgment, arguing that it complied with § 36(b) because its fees were in line with those paid by similarly situated mutual funds and the fees were approved by the funds' trustees. Petitioners opposed Harris's motion, contending that, regardless of whether Harris's fees comported with those paid by other mutual funds, those fees were significantly higher than fees paid by independent clients and therefore were excessive under § 36(b). Petitioners further argued that the facts surrounding the trustees' oversight of Harris's compensation not only failed to establish the reasonableness of the fees – because the statute precludes giving conclusive weight to board approval – but also tended to show that Harris had breached its fiduciary duty with respect to compensation, considering the board members' extensive financial and personal associations with Harris. *See* Pet. App. 18a (describing some of those associations).

In addition, because the evidence of Harris's lack of compliance with the ICA's structural requirements was undisputed, petitioners moved for summary judgment on liability. In opposing petitioners' motion, Harris contended that it had complied with the ICA's structural requirements and that, in any event, any failure to comply with the ICA's institutional safeguards was irrelevant to a breach-of-fiduciary-duty claim under § 36(b).

2. The district court granted Harris's motion for summary judgment and denied petitioners'. In denying petitioners' motion, the court concluded that an adviser's fiduciary duty under § 36(b) does not include compliance with the structural provisions on which petitioners relied. *See* Pet. App. 24a-26a. The court also asserted that the board would have

approved Harris's fees anyway and that the violations therefore were essentially harmless. *See id.* at 25a-26a.

Turning to Harris's motion, the district court opined that "the only question we need consider is whether [the funds' board] could have agreed to the fee schedule in the advisory contracts after engaging in good-faith bargaining." *Id.* at 31a. The court answered that question in the affirmative, because the evidence "indicate[d] that the board as a whole was operating without any conflict that would [have] prevent[ed] it from engaging in arm's-length negotiations with Harris," *id.*, and because Harris's fees were comparable to those paid by other mutual funds, *id.* at 30a-32a. In the court's view, it did not matter whether independent clients paid far less for services that were "indistinguishable" from those the Oakmark funds received. *Id.* at 30a.

3. a. A panel of the Seventh Circuit affirmed the district court's judgment. The panel first addressed petitioners' evidence that Harris violated its fiduciary duty with respect to compensation by failing to comply with the ICA's structural safeguards against excessive adviser fees. It concluded that the financial relationship between Morgenstern (the supposedly disinterested trustee) and Harris would violate 15 U.S.C. § 80a-15(c) only if, taking away Morgenstern, the disinterested trustees who voted to approve Harris's compensation would not have made up a majority of all disinterested trustees. *See* Pet. App. 3a-4a. Put differently, in the panel's view, the Act's requirement that a majority of the disinterested directors approve adviser compensation can be satisfied even if one of the directors participating in the approval process is, in fact, interested in the adviser

– so long as his vote is not necessary to achieve a majority. *See id.* Similarly, the panel concluded that the funds' shareholders could not recover for the failure to disclose Morgenstern's financial ties to Harris, unless Morgenstern's vote to approve Harris's fees was decisive. *See id.* at 3a.

The panel next considered petitioners' claim that Harris charged excessive investment-adviser fees, in violation of § 36(b). It noted the Second Circuit's holding in *Gartenberg* that an adviser violates § 36(b) when it charges "'a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered.'" *Id.* at 5a (quoting 694 F.2d at 928). The panel also opined that the Third and Fourth Circuits had divided on the propriety of *Gartenberg*'s interpretation of § 36(b). *See id.* at 8a (citing *Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682 (3d Cir. 2002); *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001)).

The panel "disapprove[d] the *Gartenberg* approach." *Id.* It instead held that an allegation that an adviser charged excessive fees for advisory services is not actionable under § 36(b). *See id.* The panel reasoned that "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Id.* So long as the adviser candidly negotiates with the trustees, therefore, the trustees' decision to approve the adviser's compensation is "conclusive." *Id.* at 9a.

The panel allowed that it is "possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." *Id.* But it held that such an inference could never be drawn where the adviser's compensation is "normal among similar institutions" – here, other mutual funds. *Id.*

Accordingly, the panel, like the district court, gave no weight to the fact that Harris charged more to the Oakmark funds than to its independent clients. *See id.* at 13a. (It also speculated that the Oakmark funds required more of Harris's time. *See id.*)

To support its interpretation of § 36(b), the panel analogized investment-adviser fees to compensation of fiduciaries such as corporate managers and lawyers. It asserted that courts do not review what corporate boards or clients pay officers or attorneys and drew the conclusion that "[j]udicial price-setting does not accompany fiduciary duties." *Id.* at 10a. In addition, the panel argued that its deregulatory approach was good policy. It asserted that, because there are many mutual funds, the mutual-fund industry must be competitive and that competition among mutual funds for investors' dollars must constrain adviser compensation. *See id.* at 11a-13a.

b. Petitioners sought rehearing. The Seventh Circuit's active judges split five-to-five on whether to grant rehearing, with one judge recused. Lacking a majority, the court of appeals denied rehearing. *See* Pet. App. 34a.[1]

Judge Posner, joined by Judges Rovner, Wood, Williams, and Tinder, dissented from the denial of rehearing en banc. *See id.* at 35a-43a. Judge Posner noted that the panel had "rejected the approach taken by the Second Circuit in *Gartenberg* . . . to deciding whether a mutual fund adviser has breached his fiduciary duty to the fund." *Id.* at 35a. Judge Posner explained that the panel's "rejection" of the *Gartenberg* standard was based on "an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in

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[1] *See also* 28 U.S.C. § 46(c); Fed. R. App. P. 35(a).

large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." *Id.* at 37a (citing authorities). "Competition in product and capital markets can't be counted on to solve the problem," he wrote, "because the same structure of incentives operates on all large corporations and similar entities, including mutual funds." *Id.* at 38a; *see id.* at 40a-41a. After all, Judge Posner observed, "[m]utual funds are a component of the financial services industry, where abuses have been rampant." *Id.* at 38a.

Turning to this case, Judge Posner explained that "there is no doubt that the captive funds are indeed captive" and that the "Oakmark-Harris relationship matches the arrangement described in the Senate Report accompanying § 36(b): a fund 'organized by its investment adviser which provides it with almost all management services.'" *Id.* at 39a (quoting S. Rep. No. 91-184, at 5); *see id.* at 40a (describing the relationship in greater detail). Judge Posner emphasized that a "particular concern" was Harris's practice of "charging its captive funds," in which petitioners invested, "more than twice what it charges independent funds." *Id.* at 39a. And he rejected as "airy speculation" the panel's "suggestions on why this difference may be justified" – suggestions lacking "an evidentiary or empirical basis." *Id.* at 39a, 41a. Judge Posner concluded that this case warrants further review in light of "the creation of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel's analysis." *Id.* at 42a-43a.

REASONS FOR GRANTING THE PETITION

I. THE DECISION BELOW CONFLICTS WITH DECISIONS OF THE SECOND, THIRD, AND FOURTH CIRCUITS ON A FUNDAMENTAL ISSUE OF FEDERAL SECURITIES LAW

The Seventh Circuit's decision in this case created a conflict with three other circuits in holding that an investment adviser's compensation, no matter how excessive, does not support a claim for breach of fiduciary duty under § 36(b) of the ICA, unless the adviser also misled the fund's directors in obtaining their approval of the fee. The majority rule traces its origins to the Second Circuit's decision in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). Recognizing that Congress enacted § 36(b) because the usual arm's-length bargaining over compensation arrangements does not occur between investment advisers and the funds they control, the *Gartenberg* court held that an adviser breaches its fiduciary duty under § 36(b) when its fee is so disproportionate to the services rendered that the fee evidently would not have been agreed to in an arm's-length transaction. *See id.* at 928. Both the Third and Fourth Circuits have followed the Second Circuit's approach, establishing a firm three-circuit rule, and district courts in other circuits where there is no controlling precedent likewise have favorably cited *Gartenberg*. *See* Pet. App. 36a (citing cases from courts in the First, Fifth, Eighth, Ninth, and Tenth Circuits).

In rejecting the *Gartenberg* standard, the Seventh Circuit created a division of authority in the courts of appeals on the standard for determining compliance with an investment adviser's fiduciary duty under § 36(b). Significantly, there is now a conflict between

the courts of appeals that hear cases from the country's two hubs of securities trading (New York and Chicago) on an important question of federal securities law.

A. The Second, Third, And Fourth Circuits Follow The *Gartenberg* Standard

1. *The Second Circuit.* In *Gartenberg*, shareholders in a money-market fund alleged that the fund's investment adviser charged the fund excessive fees, in violation of § 36(b). *See* 694 F.2d at 925. Like Harris, the adviser in *Gartenberg* charged the fund an advisory fee based on a percentage of the fund's net assets. *See id.* at 926.

After a bench trial, the district court ruled in favor of the adviser, finding that the "total fee was fair to the Fund." *Id.* at 927 (internal quotation marks omitted). In making that fairness determination, the court considered a number of factors, including "the nature and extent of the services, the fees charged by other advisers to other money market funds, the overall cost . . . of providing the services, and the fee schedule's allowance for economies of scale by reducing the rate as the Fund's net assets increased." *Id.* The court also "gave weight to the process by which the 6 noninterested trustees of the Fund" – whom the court found to be "competent, independent and conscientious in the performance of their duties" – approved the fee agreement. *Id.* It found that the trustees "were furnished with sufficient information to evaluate the contract" and, in fact, "thoroughly reviewed and weighed all facts pertinent to the fee" before approving it. *Id.*

In affirming, the Second Circuit explained that the fiduciary duty that § 36(b) imposes must be understood in light of the provision's purpose. Congress

enacted § 36(b) in response to the reality that "the usual arm's length bargaining between strangers does not occur between an adviser and the fund." *Id.* at 928 (citing S. Rep. No. 91-184); *see id.* at 929-30 (describing "the potentially incestuous relationships between many advisers and their funds"). Accordingly, the Second Circuit held that an investment adviser breaches its fiduciary duty under § 36(b) when the adviser charges a fee that is "so disproportionately large" – or "excessive" – that it "bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Id.* at 928, 930-31.

The Second Circuit described "pertinent facts" that a court should consider "in determining whether a fee is so excessive as to constitute a 'breach of fiduciary duty'" under § 36(b). *Id.* at 929-30. Those include "the adviser-manager's cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager." *Id.* at 930. The *Gartenberg* court also noted the importance of examining the role of the fund's trustees: "the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the adviser-manager's service and fee, and the extent of care and conscientiousness with which they perform their duties are important factors to be considered." *Id.*; *see id.* at 933. But the Second Circuit cautioned that trustee approval does not automatically establish compliance with § 36(b), because, "even if the trustees of a fund endeavored to act in a responsible fashion, an adviser-manager's fee could be so disproportionately

large as to amount to a breach of fiduciary duty in violation of § 36(b)." *Id.* at 930; *see also* 15 U.S.C. § 80a-35(b)(2).

In addition, the Second Circuit "disagree[d] with" the district court's suggestion that significant weight should be given to "the price charged by other similar advisers to funds managed by them." 694 F.2d at 929. It explained that competition between funds for shareholder business "does not support an inference that competition must therefore also exist between adviser-managers for fund business." *Id.* "The former may be vigorous," the court reasoned, "even though the latter is virtually non-existent," because "[e]ach is governed by different forces." *Id.* Therefore, the court held that an adviser's "[r]eliance on prevailing industry advisory fees will not satisfy § 36(b)." *Id.*[5]

Numerous subsequent cases in the Second Circuit have reaffirmed the *Gartenberg* standard.[6] For example, in *Meyer v. Oppenheimer Management Corp.*, 764 F.2d 76 (2d Cir. 1985), the Second Circuit

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[5] The *Gartenberg* court also observed in a footnote that – in the context of the money-market fund at issue there, which resembled "a bank account" in that "[i]dle money [could] be invested in the Fund for as little as a day and put to work earning interest," 694 F.2d at 925 – a comparison between the fees charged to the money-market fund and the fees charged to pension funds was not especially meaningful. It reasoned that a "pension fund does not face the myriad of daily purchases and redemptions throughout the nation which must be handled by" a money-market fund, "in which a purchaser may invest for only a few days." *Id.* at 930 n.3.

[6] *See, e.g., Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 117-18 (2d Cir. 2007) (per curiam); *Amron v. Morgan Stanley Inv. Advisors Inc.*, 464 F.3d 338, 340 (2d Cir. 2006); *Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409 (2d Cir. 1989).

reiterated that "[a]n investment adviser violates section 36(b) when it, or an affiliated person, charges 'a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.'" *Id.* at 81 (quoting *Gartenberg*, 694 F.2d at 928). The district court in *Meyer* had dismissed the plaintiff's claim that the adviser's fee was "excessive," relying "principally on the approval of the . . . fees by the Fund's board of directors." *Id.* at 83. Applying *Gartenberg*, the Second Circuit reversed, explaining that, "in deciding whether a fee is so high as to constitute a breach of fiduciary duty, a court should examine all the facts surrounding a fee determination." *Id.*

2. *Fourth Circuit.* In *Migdal v. Rowe Price-Fleming International, Inc.*, 248 F.3d 321 (4th Cir. 2001), shareholders in two mutual funds sued the investment advisers of those funds, alleging that they "breached their fiduciary duty under Section 36(b) because the fees they received were excessive." *Id.* at 325. Like the Second Circuit, the *Migdal* court recognized that "the typical arm's-length bargaining does not occur between an investment adviser and a mutual fund because the operations of the fund are conducted by the adviser." *Id.* at 326. The court accordingly adopted the standard that the Second Circuit applied in *Gartenberg*, holding that an adviser violates its fiduciary duty under § 36(b) when it charges a fee "'that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.'" *Id.* (quoting *Gartenberg*, 694 F.2d at 928).

Rather than following the multi-factor approach the Second Circuit articulated, however, the Fourth Circuit focused narrowly on one particular factor – "the relationship between the fees that the advisers received and the services which they provided in return." *Id.* at 327. The court upheld the dismissal of the plaintiffs' complaint because it lacked specific allegations regarding the services the advisers provided. *See id.* The court specifically noted, however, that the plaintiffs in that case had not made "any allegations about excess profits from economies of sale." *Id.* By making clear that such allegations were relevant to the inquiry about an investment adviser's breach of fiduciary duty, the Fourth Circuit's rule conflicts with the standard announced by the Seventh Circuit in this case.

3. *Third Circuit.* The year after *Migdal*, the Third Circuit confronted a § 36(b) claim in *Krantz v. Prudential Investments Fund Management LLC*, 305 F.3d 140 (3d Cir. 2002) (per curiam). There, too, an investor in a mutual fund alleged that the fund's adviser "received excessive compensation in breach of [its] 'fiduciary duty with respect to compensation' set forth in § 36(b)." *Id.* at 141 (quoting 15 U.S.C. § 80a-35(b)). Like the *Gartenberg* and *Migdal* courts, the Third Circuit recognized that an investment adviser breaches its fiduciary duty under § 36(b) when it charges a fee that is "excessive" in light of the services rendered. *Id.* at 143. Following the Fourth Circuit's interpretation of *Gartenberg* in *Migdal*, the Third Circuit required specific allegations regarding "'the relationship between the fees charged and the services rendered by the investment adviser.'" *Id.* (quoting *Migdal*, 248 F.3d at 327). Because the plaintiff "failed to allege any facts indicating that the

fees received were disproportionate to the services rendered," the court of appeals affirmed the dismissal of the case. *Id.*[7]

B. The Seventh Circuit Rejected The *Gartenberg* Standard

In this case, the Seventh Circuit broke with the governing standard in the Second, Third, and Fourth Circuits and held that an allegation that an investment adviser charged an excessive fee does not state a claim under § 36(b) of the ICA. *See* Pet. App. 8a-9a. The court below "disapprove[d] the *Gartenberg* approach." *Id.* at 9a. It held instead that the fund's "trustees . . . determine how much advisory services are worth" and that, so long as the adviser "make[s] full disclosure and play[s] no tricks," the trustees' decision to approve the fee "is conclusive." *Id.* at 8a-9a. As Judge Posner explained, in "reject[ing]" the *Gartenberg* standard, the Seventh Circuit "created a circuit split" and engendered significant confusion regarding the standard for assessing excessive-fee claims under § 36(b). *Id.* at 35a, 42a.

The court below suggested that the amount of an adviser's fee could be "so unusual that a court will infer that deceit must have occurred, or that the persons responsible for [the] decision have abdicated." *Id.* at 9a. Harris may contend that the Seventh Circuit's approach is in fact not so different from *Gartenberg*, because compensation that is "'so unusual' might not seem to differ materially from compensa-

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[7] The court below suggested that a different Third Circuit decision had rejected the *Gartenberg* standard. *See* Pet. App. 8a (citing *Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682 (3d Cir. 2002)). But, as Judge Posner explained, "the amount of compensation was not at issue" in the Third Circuit's *Green* case. *Id.* at 35a.

tion that is 'so disproportionately large.'" *Id.* at 41a (Posner, J.). But, as Judge Posner explained, such a suggestion "misses an important difference between the *Gartenberg* approach and the panel's approach": "The panel's 'so unusual' standard is to be applied solely by comparing the adviser's fee with the fees charged by other mutual fund advisers." *Id.* The Second Circuit's standard "is rightly not so limited" and would allow consideration of, among other things, the difference between the fees charged to captive funds and the fees charged to independent funds. *Id.*

II. THIS COURT SHOULD REVERSE THE SEVENTH CIRCUIT'S DECISION

The Seventh Circuit held that a shareholder's allegation that an investment adviser charged excessive fees does not, without more, state an actionable claim for relief under § 36(b). *See* Pet. App. 8a ("A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."). Instead, to state a claim, an investor would have to allege that the adviser misled the directors in some fashion. *See id.* at 9a, 13a-14a (describing the directors' decision as "conclusive," absent an allegation that the adviser "pulled the wool over the [directors'] eyes"). That holding cannot be reconciled with the ICA's text, structure, or purposes. Nor can it be squared with this Court's decisions interpreting the Act or the views of the SEC. Under a proper standard, petitioners are entitled to a trial on their claims.

A. An Adviser That Charges An Excessive Fee Breaches Its Fiduciary Duty "With Respect To The Receipt Of Compensation For Services" Under § 36(b)

1. Section 36(b) imposes on investment advisers "a fiduciary duty *with respect to the receipt of compensation for services*." 15 U.S.C. § 80a-35(b) (emphasis added). And it establishes a private right of action in favor of shareholders who have been injured by an adviser's "breach of fiduciary duty in respect of such compensation." *Id.* The statute also makes clear that, in a shareholder suit under § 36(b), "approval by the board of directors" of a fund "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.* § 80a-35(b)(2).

By its plain terms, therefore, § 36(b) not only obligates advisers to act as "fiduciar[ies]" – a status that carries with it disclosure obligations on a variety of topics in addition to fees – but also creates a specific, enforceable right "with respect to" an adviser's "receipt of compensation." *Id.* § 80a-35(b). The Seventh Circuit's assertion that § 36(b) is satisfied so long as the adviser "make[s] full disclosure and play[s] no tricks" (Pet. App. 8a) – regardless of the amount of compensation charged – thus gives short shrift to the operative phrase "with respect to the receipt of compensation," contrary to settled principles of statutory interpretation.[8] Furthermore, the lower court's decision to treat director approval as "conclusive" (*id.* at 9a) contradicts the express statutory mandate that director approval should be afforded only "such consideration by the court as is deemed

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[8] *See, e.g., Cooper Indus., Inc. v. Aviall Servs., Inc.*, 543 U.S. 157, 166 (2004).

appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2).

The Act's structure reinforces those conclusions. The ICA contains numerous provisions imposing structural safeguards on the adviser-fund relationship. In addition, § 36(a) of the ICA authorizes the SEC to seek injunctive relief against "any act or practice constituting a breach of fiduciary duty" and contains no specific language regarding the receipt of compensation. *Id.* § 80a-35(a). Thus, the ICA contains multiple provisions – other than § 36(b) – that are intended to prevent advisers from playing "tricks" or "pull[ing] the wool over" the directors' eyes. Pet. App. 8a, 13a-14a. To hold, as the court below did, that § 36(b) does nothing more than duplicate those structural and general fiduciary requirements – and imposes no substantive check on an adviser's "receipt of compensation for services," 15 U.S.C. § 80a-35(b) – negates a critical aspect of the statutory scheme Congress created.

The Seventh Circuit's rule also contradicts Congress's purposes. Congress added § 36(b) to the ICA in 1970 because the problem of excessive investment-adviser compensation had proved resistant to the structural measures adopted in 1940. Concluding that "shareholders should not have to rely solely on the fund's directors to assure reasonable adviser fees," *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991) (internal quotation marks omitted), Congress created a "mechanism by which the fairness of" those fees "could be tested in court," S. Rep. No. 91-184, at 5. The Seventh Circuit's interpretation disserves Congress's purpose, because it requires investors to rely solely on the fund's directors and

essentially negates § 36(b) as an independent mechanism to test the fairness of adviser fees.

2. The Seventh Circuit's holding in this case also conflicts with this Court's decision in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984), and with the views of the SEC. All nine Justices in *Daily Income Fund* clearly understood that "an important reason for the enactment of § 36(b)" was "to ensure reasonable adviser fees." *Id.* at 534 n.10; *see also id.* at 546 (Stevens, J., concurring in the judgment) (indicating that Congress intended to enable shareholders to challenge and to recover "excessive fees"). The Court there recognized that a major flaw in the existing rules governing shareholder actions against investment advisers was that courts too often deferred to director approval in denying relief. *See id.* at 537, 540 & n.12. Accordingly, the Court explained, Congress created a new federal standard for shareholder actions, "to act as [an] independent check[] on excessive fees." *Id.* at 541.[9] Yet, the court below read that independent check right out of the U.S. Code, reducing the provision to a prohibition on misleading or defrauding a fund's directors.

The lower court's ruling similarly conflicts with the SEC's views. In its brief in *Daily Income Fund*, the SEC explained that § 36(b) grants shareholders a "right to sue investment advisers *in order to recover excessive fees*." Brief for the SEC as Amicus Curiae in Support of Affirmance at 2, *Daily Income Fund*,

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[9] Although no party in *Daily Income Fund* argued for a contrary reading of the statute, this Court's conclusion was an essential premise of its holding that a demand on the fund's board of directors under Federal Rule of Civil Procedure 23.1 is not a prerequisite to a shareholder action under § 36(b). *See* 464 U.S. at 534-42.

Inc. v. Fox, 464 U.S. 523 (1984) (No. 82-1200) ("SEC *Daily Income Fund* Brief") (emphasis added). According to the SEC, "[s]ecurity holder suits under Section 36(b) provide a necessary supplement to the Commission's own enforcement authority under this Section." *Id.* The SEC also understood that director approval of a fee cannot be "conclusive," as the lower court held, Pet. App. 9a, because the statute "reflects a congressional determination that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors." SEC *Daily Income Fund* Brief at 9. Indeed, the SEC characterized the need to provide effective judicial review of adviser fees as a "major impetus" for the 1970 Amendments to the ICA. *Id.* at 5. The inconsistency between the decision below and the views of the expert agency entrusted with implementing and enforcing the ICA further underscores the importance of granting review.

B. The Seventh Circuit's Policy Arguments And Analogies To Other Sources Of Law Do Not Support Its Interpretation Of The Act

The principal support for the Seventh Circuit's holding was its assertion that competition among mutual funds for shareholders' business will constrain adviser fees. *See* Pet. App. 7a, 11a-13a. But, as Judge Posner maintained, that conclusion rests on "an economic analysis that is ripe for reexamination." *Id.* at 37a. In addition to the growing body of scholarly work documenting "the feeble incentives of boards of directors to police compensation," *id.*, the panel's reasoning ignores that "the same structure of incentives operates" on all mutual funds, *id.* at 38a.

Thus, high fees are unlikely to drive mutual fund investors away, because fees are similar across the industry. *See id.* at 40a.

The Seventh Circuit also asserted that other fiduciaries are not held liable for charging excessive fees. *See id.* at 8a-10a. But the court misunderstood the other sources of law to which it looked, and its analogies are not apt. Under the law of trusts, which the court below invoked, it is not true that a fiduciary may accept whatever compensation is agreed on. Instead, "[i]f the amount of compensation provided by the terms of the trust is or becomes unreasonably high or unreasonably low, the court may allow a smaller or larger compensation." *Restatement (Third) of Trusts* § 38 cmt. e (2001).[10] The panel's analogy to lawyer compensation, *see* Pet. App. 10a, similarly is misplaced, because "[a] lawyer may not charge a fee larger than is reasonable in the circumstances." *Restatement (Third) of Law Governing Lawyers* § 34 (2000).

Nor does the panel's observation that courts ordinarily do not second-guess the compensation of corporate officers support its conclusion. Because Congress enacted § 36(b) in response to the inadequacy of existing state corporate-law standards governing excessive-compensation claims – standards that often required a showing of "corporate waste,"

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[10] *See also Restatement (Second) of Trusts* § 242 cmt. f (1959) ("If by an abuse of a fiduciary or confidential relationship existing between the trustee and the settlor at the time of the creation of the trust, the settlor is induced to provide that the trustee shall receive more than a reasonable compensation, the trustee is not entitled to the compensation provided by the terms of the trust but only to such compensation as is reasonable.").

Daily Income Fund, 464 U.S. at 540 n.12 – it would be absurd to rely on those same standards to narrow the statute's scope. Moreover, Congress's greater concern over the compensation of investment advisers than that of corporate officers makes sense. As courts and scholars have recognized, conflicts of interest "occur[] much more frequently in the relations between a mutual fund and its investment adviser than in ordinary business corporations." *Fogel v. Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975) (Friendly, J.); *see* Donald C. Langevoort, *Private Litigation To Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 Wash. U. L.Q. 1017, 1032 (2005) (explaining that "[t]hinking about mutual funds . . . as a species of 'corporations' . . . is completely misguided").

C. Under A Proper Standard, Petitioners' Evidence Justifies A Trial On The Merits

Evaluated under a correct legal standard, petitioners' evidence was more than sufficient to raise genuine issues of material fact for trial. Most significantly, it is undisputed that Harris charged the Oakmark funds more than twice what it charged independent, institutional investors that it advises. *See* Pet. App. 6a, 17a, 39a. That comparison to fees negotiated through actual arm's-length bargaining alone suffices to support a finding that Harris's fees were "so disproportionately large" that they bore "no reasonable relationship to the services rendered." *Gartenberg*, 694 F.2d at 928; *see Strigliabotti v. Franklin Res., Inc.*, No. C 04-00883 SI, 2005 WL 645529, at *3-*4 (N.D. Cal. Mar. 7, 2005) (denying motion to dismiss § 36(b) claim where plaintiffs alleged that the adviser charged the fund significantly

more than it charged institutional investors for equivalent services); *see also Daily Income Fund*, 464 U.S. at 537 (explaining that Congress enacted § 36(b) partly as a response to investment advisers' practice of charging "mutual funds higher fees than those charged the advisers' other clients"). Indeed, the evidence here showed not only that Harris charged the Oakmark funds more than institutional clients, but also that it cost Harris significantly *less* to serve the institutional clients. *See* C.A. App. A145. In addition, the record contained ample evidence that Harris was enjoying significant, and increasing, economies of scale, exacerbating the discrepancy between its fees and the cost of providing the services it rendered. *See id.* at A137-A142.

It is no answer to assert, as did the panel below, that the fees paid by the Oakmark funds resemble the fees paid by other mutual funds. As Judge Posner explained, "[t]he governance structure that enables mutual fund advisers to charge exorbitant fees" – the structure to which Congress responded in enacting § 36(b) – "is industry-wide." Pet. App. 41a. Consequently, the panel's approach would "allow those fees to become the industry's floor." *Id.*

Petitioners also demonstrated that Harris violated the ICA's structural protections against excessive adviser compensation in multiple ways. They showed that Harris had secured approval of its fees from a group of supposedly disinterested trustees that in fact included a former Harris partner with a continuing financial interest in Harris worth hundreds of thousands of dollars per year, in violation of § 15(c) of the ICA, 15 U.S.C. § 80a-15(c). *See supra* p. 7. Petitioners also demonstrated that Harris had failed to report to the SEC and the investing public

its continuing financial relationship with the board's supposedly disinterested chair, in violation of § 34(b) of the ICA, 15 U.S.C. § 80a-33(b). *See supra* p. 7.[11] In addition, petitioners adduced substantial other evidence of Harris's breaches of its fiduciary duty under § 36(b), including:

- failing to disclose that three supposedly disinterested trustees were heavily invested in hedge funds managed by a corporate affiliate of Harris, *see* C.A. App. A85-A86, A88;
- misleading the board about its profitability, *see id.* at A130-A137;
- failing to provide the board with information about its economies of scale, *see id.* at A137-A139;
- resisting the board's efforts to institute breakpoints – that is, decreases in the fee percentage on assets exceeding a certain amount – and threatening to close one of the funds to new investors if breakpoints were instituted that

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[11] To resolve the question presented, the Court need not decide whether a violation of § 15(c) or § 34(b) of the ICA is, in and of itself, sufficient to establish a breach of fiduciary duty actionable under § 36(b) (an issue the court below did not directly address, although it was properly presented). For present purposes, it is sufficient to recognize that evidence of violations of those provisions is relevant to, and highly probative on, the issue of whether an adviser has breached its fiduciary duty under § 36(b). *See, e.g., Krinsk*, 875 F.2d at 409 (explaining that "the independence . . . of the trustees" is a factor to be considered in applying the *Gartenberg* standard); *Gartenberg*, 694 F.2d at 929 (holding that, under § 36(b), "all pertinent facts must be weighed"); *see also Galfand v. Chestnutt Corp.*, 545 F.2d 807, 809 (2d Cir. 1976) (holding that investment adviser violated § 36(b) by obtaining a "one-sided revision" of its advisory contract without full disclosure to the board).

would impact Harris's profits, *see id.* at A140-A142;

- misleading the board about the extent and cost of the services it provided to its other clients in comparison to the mutual funds, *see id.* at A146-A148;
- misleading the board about its use of a Harris affiliate to double-charge the funds for commissions, *see id.* at A148-A149; and
- misleading the board in an effort to cause the funds to pay increased distribution payments to intermediaries who sold shares of the funds, *see id.* at A149-A151.

By failing to discuss that evidence in analyzing petitioners' § 36(b) claim, the Seventh Circuit implicitly deemed it irrelevant (or at least insufficient to raise a triable issue of fact) under the standard the court adopted. For this reason, the lower court's holding is doubly pernicious. It erroneously held that the size of an adviser's fee ordinarily cannot be the basis of a claim for breach of fiduciary duty under § 36(b) and required shareholders to prove that the adviser "pulled the wool over the eyes of the disinterested trustees" that approved its compensation. Pet. App. 13a-14a. At the same time, however, the court ignored substantial evidence that Harris engaged in exactly the type of "tricks" that the court suggested would form the basis of an actionable § 36(b) claim. *Id.* at 8a.

III. THIS CASE PRESENTS A RECURRING QUESTION OF EXCEPTIONAL IMPORTANCE WARRANTING THE COURT'S IMMEDIATE RESOLUTION

This case raises a question of vital importance to investors in mutual funds – whether the excessiveness of an investment adviser's fee can support a claim for breach of fiduciary duty under § 36(b). The significant number of reported federal appellate opinions addressing the issue in recent years reflects that the issue is one of recurring significance.[12] And the circuits with some of the largest mutual funds in the nation – the Second Circuit (Merrill Lynch), the Third Circuit (Vanguard), and the Fourth Circuit (T. Rowe Price) – now have firmly established rules. The question presented is ripe for this Court's review, and this case presents an ideal vehicle in which to resolve it.

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[12] *See Bellikoff*, 481 F.3d 110; *Amron*, 464 F.3d 338; *Krantz*, 305 F.3d 140; *Migdal*, 248 F.3d 321. In addition, a case presenting the propriety of the *Gartenberg* standard is pending in the Eighth Circuit. *See* Am. Mem. Op. and Order, *Gallus v. Ameriprise Fin., Inc.*, Civil No. 04-4498 (D. Minn. July 10, 2007), *appeal pending*, No. 07-2945 (8th Cir. argued Apr. 17, 2008). The decision below has been brought to the attention of the Eighth Circuit panel. Regardless of whether the Eighth Circuit follows *Gartenberg*, the reasoning of the Seventh Circuit in this case, or strikes out on its own, the outcome of the Eighth Circuit appeal can only deepen the circuit conflict, and the pendency of that case underscores the recurring significance of the question presented.

A. The Standard For Claims Of Breach Of Fiduciary Duty Under § 36(b) Affects Millions Of Shareholders, Who Have Trillions Of Dollars Invested In Mutual Funds

Mutual funds play a critical role in the national economy. Nearly 51 million U.S. households, or about 44 percent of American families, and 88 million individuals own mutual funds.[13] As of August 2008 (before the stock-market crash of October 2008), investors held more than $11.5 trillion in retirement and personal savings in mutual funds.[14]

The consequences of the Seventh Circuit's decision are well explained in a litigation alert posted on the website of Harris's counsel the day after the decision issued. It declared that the ruling "eras[es] nearly 30 years of precedent and practice" that grew out of the widely applied *Gartenberg* decision.[15] The alert also suggested that, at least in the Seventh Circuit, the holding could "influence" – presumably by relaxing – directors' review of adviser fees. *See* Litigation Alert at 2.[16]

Thus, as Harris's counsel evidently acknowledges, the Seventh Circuit's decision not only restricts

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[13] *See 2007 Trends in Ownership* at 1.

[14] *See Trends in Mutual Fund Investing.*

[15] Ropes & Gray, *Appeals Court Rejects Mutual Fund Excessive Fee Claims, Adopting New Standard for Evaluation of Fees* 1 (May 20, 2008) ("Litigation Alert"), *available at* http://www.ropesgray.com/litigationalert/?PublicationTypes=0c16874b-f94e-4696-b607-de259b87a13f.

[16] *See also* Floyd Norris, *Fund Fees Revisited In Court*, N.Y. Times, May 23, 2008, at C1 (opining that if the decision below "becomes widely accepted it could lead boards to forgo the often extensive process of gathering information to determine if fees are reasonable").

investors' ability to recover excessive adviser fees, but also reduces incentives for directors to provide rigorous oversight of adviser compensation. Moreover, for both advisers of and investors in large nationwide fund complexes, the conflict and confusion in the circuits creates the possibility of disparate results depending on the venue in which a suit is heard. This Court's intervention is required to restore uniformity in the interpretation and application of § 36(b).

B. The Question Presented Is Ripe For The Court's Review, And This Case Is An Ideal Vehicle For Resolving It

The Court will not benefit from further percolation of this issue in the lower courts. The proper standard for addressing an excessive-fee claim under § 36(b) of the ICA has now been discussed in the courts of appeals for more than a quarter century. Four circuits have fully considered the issue, with three following the *Gartenberg* standard and holding that an adviser breaches its fiduciary duty under § 36(b) when it charges a fee disproportionate to the services rendered, such that it would not have been agreed to by parties bargaining at arm's length. *See supra* pp. 14-19. The Seventh Circuit has now reached a contrary conclusion, holding that excessive-fee claims generally are not cognizable under § 36(b). *See supra* pp. 19-20. The court below acknowledged that conflict, *see* Pet. App. 8a; *id.* at 35a, 42a-43a (Posner, J.), as have a host of legal commentators, *see id.* at 42a (citing sources). The conflict is thus fully developed.

Furthermore, there is no realistic prospect of the conflict being resolved without this Court's intervention. The Seventh Circuit denied rehearing on the question, *see id.* at 34a, over Judge Posner's dissent,

which argued that "the creation of a circuit split" warranted en banc review, *id.* at 42a-43a. Numerous (and recent) Second Circuit decisions have adhered to the approach in *Gartenberg*, and there is no reason to believe that court will deviate from the standard set forth in that case. *See supra* p. 16 & note 6. Accordingly, the question presented is ripe for adjudication by this Court. Declining to intervene will only lead to further confusion and inconsistent results in the lower courts.

In addition, this case is an ideal vehicle for resolving the question presented. There is no preliminary or threshold issue that this Court would have to decide before reaching the question presented. Nor is there any alternative ground for affirming the district court's grant of summary judgment for Harris if the Court reverses the decision below.

Furthermore, this case is a particularly good vehicle for addressing whether, as Judge Posner opined, the comparison between the fees an adviser charges its captive funds and the fees it charges its independent clients has probative value under § 36(b). The record here contains specific evidence on Harris's costs to serve each type of client – such as the number of Harris employees dedicated to managing the funds versus the number of employees dedicated to other clients. *See* C.A. App. A145. Such evidence is not available in all cases, and it makes this case an extraordinarily good vehicle for addressing whether the disparity between fees charged to different types of investment clients can support a claim for breach of fiduciary duty under § 36(b).

CONCLUSION

The petition for writ of certiorari should be granted.

Respectfully submitted,

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November 3, 2008

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UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 07-1624

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Plaintiffs-Appellants,

v.

HARRIS ASSOCIATES L.P.,
Defendant-Appellee.

Argued Sept. 10, 2007

Decided May 19, 2008

Appeal from the United States District Court
for the Northern District of Illinois, No. 04 C 8305

Before EASTERBROOK, Chief Judge, and KANNE and EVANS, Circuit Judges.

EASTERBROOK, Chief Judge.

Harris Associates advises the Oakmark complex of mutual funds. These open-end funds (an open-end fund is one that buys back its shares at current asset value) have grown in recent years because their net returns have exceeded the market average, and the investment adviser's compensation has grown apace. Plaintiffs, who own shares in several of the Oakmark funds, contend that the fees are too high and thus

violate § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b), a provision added in 1970. The district court concluded that Harris Associates had not violated the Act and granted summary judgment in its favor. 2007 U.S. Dist. LEXIS 13352 (N.D. Ill. Feb. 27, 2007).

Plaintiffs rely on several sections of the Act in addition to § 36(b), and we can make short work of these. The Act requires at least 40% of a mutual fund's trustees to be disinterested in the adviser, see 15 U.S.C. § 80a-10(a), and obliges the fund to reveal the financial links between its trustees and the adviser, see 15 U.S.C. § 80a-33(b). Compensation for the adviser is controlled by a majority of the disinterested trustees. 15 U.S.C. § 80a-15(c). Plaintiffs say that the Oakmark funds have violated all of these rules. Because none of the funds is a party to this suit, an order directing the funds to comply is not available as relief. Plaintiffs say that the court could require Harris to return the compensation it has received, but such a penalty would be disproportionate to the wrong. That's not the only problem: although § 36(b) creates a private right of action, the other sections we have mentioned do not. We need not decide whether a private right of action should be implied, see *Alexander v. Sandoval*, 532 U.S. 275, 121 S.Ct. 1511, 149 L.Ed.2d 517 (2001), or whether a sensible remedy could be devised, as there has been no violation of § 10(a) or § 15(c).

Victor Morgenstern is among the funds' trustees. Until the end of 2000, when he retired, Morgenstern was a partner of Harris Associates and counted among the funds' "interested" trustees. Since his retirement, Morgenstern has been treated as a disinterested trustee and has voted at the special

meetings that deal with the adviser's compensation. Plaintiffs insist that Morgenstern does not meet the statutory standards because Harris Associates bought out his partnership with a stream of payments that can be deferred if Harris does not satisfy performance benchmarks in a given year. This makes the payments a form of profit sharing, plaintiffs contend, and because profit-sharing agreements are treated as "securities" under 15 U.S.C. § 80a-2(a)(36), Morgenstern owns securities in Harris Associates and is not disinterested. 15 U.S.C. § 80a-2(a)(19)(B)(iii). Moreover, plaintiffs continue, the Oakmark funds did not disclose these facts to the public and so are out of compliance with 15 U.S.C. § 80a-33(b).

Harris Associates contends that payments fixed in amount are not "profit sharing" in the statutory sense just because the time of payment is uncertain. Let us assume (again without deciding) that Morgenstern held a "security" under the Act because he was exposed to the risk of business reverses at his old firm. Failure to disclose Morgenstern's post-retirement payments from Harris Associates might support an order directing the funds to correct their annual reports and other official disclosure documents but would not justify any relief against Harris Associates. To get anywhere, even with a private right of action, plaintiffs would have to show the sort of violation that knocks out any valid contract between Harris Associates and the funds. Only a violation of the 40%-independence rule or the approval-by-a-majority-of-disinterested-trustees rule could do that. Yet most of the funds' trustees are disinterested even if Morgenstern is treated as interested.

During the time covered by the suit, the funds had nine or ten trustees, at least seven of whom are

independent even if we count Morgenstern as interested. That's comfortably over the statutory requirement that 40% of trustees be disinterested. And as the disinterested trustees unanimously approved the contracts with Harris Associates, it makes no difference how Morgenstern is classified. Plaintiffs ask us to suppose that Morgenstern possessed some Svengali-like sway over the other trustees, so that his presence in the room was enough to spoil their decisions. But in 2000 and before, when Morgenstern had been treated as interested, the disinterested trustees met in his absence and approved Harris's compensation. More: although the disinterested directors initially meet separately, the whole board ultimately discusses and votes on the contract. 15 U.S.C. § 80a-15(a)(2). Interested directors are not silenced. So it is impossible to see how Morgenstern's role from 2001 through 2004 can be treated as poisoning the deliberations.

Now for the main event: plaintiffs' contention that the adviser's fees are excessive. They rely on § 36(b), which provides:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser.

> . . . With respect to any such action the following provisions shall apply:
>
> (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.
>
> (2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances. . . .

The district court followed *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), and concluded that Harris Associates must prevail because its fees are ordinary. *Gartenberg* articulated two variations on a theme:

> [T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances.

694 F.2d at 928. And

> [t]o be guilty of a violation of § 36(b) . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining.

Ibid. Oakmark Fund paid Harris Associates 1% (per year) of the first $2 billion of the fund's assets, 0.9% of the next $1 billion, 0.8% of the next $2 billion, and 0.75% of anything over $5 billion. The district court's opinion sets out the fees for the other funds; they are similar. It is undisputed that these fees are roughly the same (in both level and breakpoints) as those that other funds of similar size and investment goals pay their advisers, and that the fee structure is lawful under the Investment Advisers Act. See 15 U.S.C. § 80b-5. The Oakmark funds have grown more than the norm for comparable pools, which implies that Harris Associates has delivered value for money.

Plaintiffs contend that we should not follow *Gartenberg*, for two principal reasons: first, that the second circuit relies too much on market prices as the benchmark of reasonable fees, which plaintiffs insist is inappropriate because fees are set incestuously rather than by competition; second, that if any market should be used as the benchmark, it is the market for advisory services to unaffiliated institutional clients. The first argument stems from the fact that investment advisers create mutual funds, which they dominate notwithstanding the statutory requirement that 40% of trustees be disinterested. Few mutual funds ever change advisers, and plaintiffs conclude from this that the market for advisers is not competitive. The second argument rests on the fact that Harris Associates, like many other investment advisers, has institutional clients (such as pension funds) that pay less. For a client with investment goals similar to Oakmark Fund, Harris Associates charges 0.75% of the first $15 million under management and 0.35% of the amount over $500 million, with intermediate breakpoints. Plaintiffs maintain that a fiduciary

may charge its controlled clients no more than its independent clients.

Like the plaintiffs, the second circuit in *Gartenberg* expressed some skepticism of competition's power to constrain investment advisers' fees.

> Competition between [mutual] funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business. The former may be vigorous even though the latter is virtually non-existent. Each is governed by different forces.

694 F.2d at 929. The second circuit did not explain *why* this is so, however. It was content to rely on the observation that mutual funds rarely advertise the level of their management fees, as distinct from the funds' total expenses as a percentage of assets (a widely publicized benchmark).

Holding costs down is vital in competition, when investors are seeking maximum return net of expenses – and as management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with higher return on investment. A difference of 0.1% per annum in total administrative expenses adds up by compounding over time and is enough to induce many investors to change mutual funds. That mutual funds are "captives" of investment advisers does not curtail this competition. An adviser can't make money from its captive fund if high fees drive investors away.

So just as plaintiffs are skeptical of *Gartenberg* because it relies too heavily on markets, we are skeptical about *Gartenberg* because it relies too little on

markets. And this is not the first time we have suggested that *Gartenberg* is wanting. See *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 743 n.8 (7th Cir. 2002). Two courts of appeals (in addition to the second circuit) have addressed claims against the advisers of open-end mutual funds. One circuit has followed *Gartenberg*. See *Migdal v. Rowe Price-Fleming International, Inc.*, 248 F.3d 321 (4th Cir. 2001). The other has concluded that adherence to the statutory procedures, rather than the level of price, is the right way to understand the "fiduciary" obligation created by § 36(b). See *Green v. Fund Asset Management, L.P.*, 286 F.3d 682 (3d Cir. 2002). Our own *Green* opinion, though it dealt with the obligations of advisers to closed-end funds, indicated sympathy for the third circuit's position.

Having had another chance to study this question, we now disapprove the *Gartenberg* approach. A fiduciary duty differs from rate regulation. A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees (and in the end investors, who vote with their feet and dollars), rather than a judge or jury, determine how much advisory services are worth.

Section 36(b) does not say that fees must be "reasonable" in relation to a judicially created standard. It says instead that the adviser has a fiduciary duty. That is a familiar word; to use it is to summon up the law of trusts. *Cf. Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 109 S.Ct. 948, 103 L.Ed.2d 80 (1989). And the rule in trust law is straightforward: A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay. *Restatement (Second)*

of Trusts § 242 & comment f. When the trust instrument is silent about compensation, the trustee may petition a court for an award, and then the court will ask what is "reasonable"; but when the settlor or the persons charged with the trust's administration make a decision, it is conclusive. John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L.J. 625 (1995). It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated – for example, if a university's board of trustees decides to pay the president $50 million a year, when no other president of a comparable institution receives more than $2 million – but no court would inquire whether a salary normal among similar institutions is excessive.

Things work the same way for business corporations, which though not trusts are managed by persons who owe fiduciary duties of loyalty to investors. This does not prevent them from demanding substantial compensation and bargaining hard to get it. Publicly traded corporations use the same basic procedures as mutual funds: a committee of independent directors sets the top managers' compensation. No court has held that this procedure implies judicial review for "reasonableness" of the resulting salary, bonus, and stock options. These are constrained by competition in several markets – firms that pay too much to managers have trouble raising money, because net profits available for distribution to investors are lower, and these firms also suffer in product markets because they must charge more and consumers turn elsewhere. Competitive processes are imperfect but remain superior to a "just price" system administered by the judiciary. However weak

competition may be at weeding out errors, the judicial process is worse – for judges can't be turned out of office or have their salaries cut if they display poor business judgment.

Lawyers have fiduciary duties to their clients but are free to negotiate for high hourly wages or compensation from any judgment. Rates over $500 an hour and contingent fees exceeding a third of any recovery are common. The existence of the fiduciary duty does not imply judicial review for reasonableness; the question a court will ask, if the fee is contested, is whether the client made a voluntary choice *ex ante* with the benefit of adequate information. Competition rather than litigation determines the fee – and, when judges must set fees, they try to follow the market rather than demand that attorneys' compensation conform to the judges' preferences. See, e.g., *In re Synthroid Marketing Litigation*, 325 F.3d 974 (7th Cir. 2003); *In re Continental Illinois Securities Litigation*, 962 F.2d 566 (7th Cir. 1992). A lawyer cannot deceive his client or take strategic advantage of the dependence that develops once representation begins, but hard bargaining and seemingly steep rates are lawful.

The list could be extended, but the point has been made. Judicial price-setting does not accompany fiduciary duties. Section 36(b) does not call for a departure from this norm. Plaintiffs ask us to look beyond the statute's text to its legislative history, but that history, which *Gartenberg* explores, is like many legislative histories in containing expressions that seem to support every possible position. Some members of Congress equated fiduciary duty with review for reasonableness; others did not (language that would have authorized review of rates for reason-

ableness was voted down); the Senate committee report disclaimed any link between fiduciary duty and reasonableness of fees. See 694 F.2d at 928.

Statements made during the debates between 1968 and 1970 rest on beliefs about the structure of the mutual-fund market at the time, and plaintiffs say that because many members of Congress deemed competition inadequate (and regulation essential) in 1970, we must act as if competition remains weak today. Why? Congress did not enact its members' *beliefs*; it enacted a text. A text authorizing the SEC or the judiciary to set rates would be binding no matter how market conditions change. Section 36(b) does not create a rate-regulation mechanism, and plaintiffs' proposal to create such a mechanism in 2008 cannot be justified by suppositions about the market conditions of 1970. A lot has happened in the last 38 years.

Today thousands of mutual funds compete. The pages of the *Wall Street Journal* teem with listings. People can search for and trade funds over the Internet, with negligible transactions costs. "At the end of World War II, there were 73 mutual funds registered with the Securities and Exchange Commission holding $1.2 billion in assets. By the end of 2002, over 8,000 mutual funds held more than $6 trillion in assets." Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. Econ. Perspectives 162, 162 (Spring 2004). Some mutual funds, such as those that track market indexes, do not have investment advisers and thus avoid all advisory fees. (Total expenses of the Vanguard 500 Index Fund, for example, are under 0.10% of assets; the same figure for the Oakmark Fund in 2007 was 1.01%.) Mutual funds rarely fire their investment advisers, but investors

can and do "fire" advisers cheaply and easily by moving their money elsewhere. Investors do this not when the advisers' fees are "too high" in the abstract, but when they are excessive in relation to the results – and what is "excessive" depends on the results available from other investment vehicles, rather than any absolute level of compensation.

New entry is common, and funds can attract money only by offering a combination of service and management that investors value, at a price they are willing to pay. Mutual funds come much closer to the model of atomistic competition than do most other markets. Judges would not dream of regulating the price of automobiles, which are produced by roughly a dozen large firms; why then should 8,000 mutual funds seem "too few" to put competitive pressure on advisory fees? A recent, careful study concludes that thousands of mutual funds are plenty, that investors can and do protect their interests by shopping, and that regulating advisory fees through litigation is unlikely to do more good than harm. See John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 Iowa J. Corp. L. 151 (2007).

It won't do to reply that most investors are unsophisticated and don't compare prices. The sophisticated investors who do shop create a competitive pressure that protects the rest. See Alan Schwartz & Louis Wilde, *Imperfect Information in Markets for Contract Terms*, 69 Va. L. Rev. 1387 (1983). As it happens, the most substantial and sophisticated investors choose to pay substantially more for investment advice than advisers subject to § 36(b) receive. A fund that allows only "accredited investors" (i.e., the wealthy) to own non-redeemable shares is exempt

from the Investment Company Act. See 15 U.S.C. § 80a-6(a)(5)(A)(iii). Investment pools that take advantage of this exemption, commonly called hedge funds, regularly pay their advisers more than 1% of the pool's asset value, plus a substantial portion of any gains from successful strategies. See René M. Stulz, *Hedge Funds: Past, Present, and Future*, 21 J. Econ. Perspectives 175 (Spring 2007). See also Joseph Golec & Laura Starks, *Performance fee contract change and mutual fund risk*, 73 J. Fin. Econ. 93 (2004). When persons who have the most to invest, and who act through professional advisers, place their assets in pools whose managers receive more than Harris Associates, it is hard to conclude that Harris's fees must be excessive.

Harris Associates charges a lower percentage of assets to other clients, but this does not imply that it must be charging too much to the Oakmark funds. Different clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions. That complicates an adviser's task. Joint costs likewise make it hard to draw inferences from fee levels. Some tasks in research, valuation, and portfolio design will have benefits for several clients. In competition those joint costs are apportioned among paying customers according to their elasticity of demand, not according to any rule of equal treatment.

Federal securities laws, of which the Investment Company Act is one component, work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choices. Plaintiffs do not contend that Harris Associ-

ates pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services. The fees are not hidden from investors – and the Oakmark funds' net return has attracted new investment rather than driving investors away. As § 36(b) does not make the federal judiciary a rate regulator, after the fashion of the Federal Energy Regulatory Commission, the judgment of the district court is affirmed.

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

Feb. 27, 2007

MEMORANDUM OPINION

CHARLES P. KOCORAS, District Judge.

This matter comes before the court on cross motions for summary judgment. For the reasons set forth below, Plaintiffs' motion for summary judgment is denied and Harris's motion for summary judgment is granted.

BACKGROUND

During the time relevant to Plaintiffs' complaint, Defendant Harris Associates LP ("Harris") served as an investment adviser to three mutual funds (collectively referred to as "the Funds"): the Oakmark Fund ("Oakmark"), the Oakmark Equity and Income Fund ("Equity"), and the Oakmark Global Fund ("Global").[1]

[1] The parties have not provided any specific attributes of the Funds other than they are each a mutual fund and a registered

Plaintiffs Jerry and Mary Jones have been shareholders in Equity since December 2003 and in Global since March 2004. Plaintiff Arline Winerman has held shares in Oakmark since December 2003. The services Harris rendered to the Funds included research and stock selection.

For its services as investment advisor, Harris received a fee that was calculated according to a contractual schedule. The contracts containing the fee schedules were approved on a yearly basis by the Funds' board of trustees. Before approval, a committee of board members met several times to review information from Harris regarding the funds' performance, the services Harris provided to the Funds, comparisons with fees charged to Harris's other clients, and comparisons with fees charged by other companies managing similar funds. The committee attended presentations from the Funds' managers and made recommendations to the full board on whether to approve the contracts. For the period at issue, the applicable contracts went through this approval process and were approved by the board. The resulting fees were calculated as a percentage of a Fund's assets at the end of the preceding month.

In addition to managing the Funds, Harris also provided services to sub-advised funds (other mutual funds for which Harris was not the primary investment adviser), "separate account" clients, and limited partnerships (collectively referred to herein as "institutional clients"). The services Harris provided to institutional clients varied, but in all events were more limited than those they provided to the Funds.

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investment company under the Investment Company Act. 15 U.S.C. § 80a-1 *et seq.*

The fee schedules applied to different types of clients also varied. For the applicable damages period for Oakmark of August 2003 to August 2004,[2] the fee was 1% of the first $2 billion of the Fund's assets, 0.9% for the next $1 billion, 0.8% for the next $2 billion, and then 0.75% for assets in excess of $5 billion. These reductions as the Fund's assets grew are referred to as "breakpoints." For institutional clients with investment strategies similar to Oakmark's, the percentages ranged from 0.75% to 0.35%, with breakpoints ranging from $15 million to $500 million. For the fiscal year ending in September 2004, Oakmark paid $50,652,178 in advisory fees for Harris's services – $13,577,704 more than the previous year. According to the Funds' expert, during the applicable damages period Oakmark paid Harris $46,698,385 in fees.

For Equity, as of November 2003, the fee schedule was 0.75% for the first $5 billion of assets, 0.7% on the next $2.5 billion, 0.675% on the next $2.5 billion, and then 0.65% for assets above the $10 billion mark. For institutional clients with similar investment strategies, the fee percentages began at 1% and went as low as 0.25%. Breakpoints varied from $10 million to $400 million. For the fiscal year ending in September 2004, Equity paid Harris $46,997,810- $23,529,291 more than the year before. According to the Funds' expert, during the applicable damages period, Equity paid $39,622,122.

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[2] Damages in an action for breach of the fiduciary duty at issue in this case are limited to the year preceding the commencement of the action. 15 U.S.C. § 80a-35(b)(3). As the original complaint in this action was filed August 17, 2004, the applicable damages period for this case would be restricted to the year preceding that date.

For Global, again as of November 2003, the fee schedule began as for Oakmark, at 1% of the first $2 billion. It then decreased to 0.95% for the next $2 billion and then to 0.9% for assets in excess of $4 billion. For institutional clients with similar investment strategies, the corresponding percentages began at 0.85% and progressed down to 0.5%, with breakpoints from $25 million to $100 million. For the fiscal year ending in September 2004, Global paid $12,245,761 in advisory fees, $9,263,669 more than the year before. According to the Funds' expert, Global paid $7,391,044 during the applicable damages period.

During the relevant time period, the Funds' board of trustees was comprised of nine or ten members: Victor Morgenstern, Gary Wilner, Burton Ruder, Marvin Rotter, Michael Friduss, Allan Reich, Thomas Hayden, Christine Maki, Peter Voss, and, beginning in July 2003, John Raitt. Morgenstern retired from Harris in 2001 after working there for many years. He has social and business relationships with people who continued to work for Harris after his departure. Rotter and Reich also have social and business relationships with Harris employees. Morgenstern, Wilner, and Ruder are neighbors; they have vacationed together, and their children are contemporaries. Morgenstern, Wilner, Ruder, and Rotter have been partners in different business ventures, some of which Morgenstern introduced to the others. Morgenstern and Friduss are longtime friends. Voss was the CEO and president of Harris's parent company; Raitt became CEO and President of Harris on July 16, 2003.

On August 17, 2004, Plaintiffs filed suit in the Western District of Missouri.[3] Plaintiffs brought this action derivatively on behalf of the Funds, alleging that Harris violated § 36(b) of the Investment Company Act of 1940, codified at 15 U.S.C. § 80a-35(b). In pertinent part, § 36(b) provides that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid . . . to such investment adviser or any affiliated person of such investment adviser." Subsection (b)(1) states that "[i]t shall not be necessary to . . . prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty."

The complaint consisted of two counts. The first alleged that the advisory fees paid to Harris were so disproportionate to the value of its services that it breached its fiduciary duty under § 36(b) by receiving them. The second contended that Harris impermissibly retained savings it realized from economies of scale as the Funds grew, thereby making its effective compensation even higher than the fees listed above.

In November 2004, Harris moved to dismiss the complaint for failure to state a claim. While the motion was pending, the suit was transferred to our district. The following April, we denied the motion

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[3] The original complaint was brought by the Joneses and another plaintiff named Olga Menyhart, who owned shares in Oakmark and another fund called the Oakmark International Fund. Thereafter, Menyhart sold her shares in both funds, and Plaintiffs amended the complaint to drop Menyhart and add Winerman, as well as removing any mention of the Oakmark International Fund.

and the parties engaged in fact and expert discovery. After that process was completed, the parties briefed and orally argued the instant cross motions for summary judgment.

LEGAL STANDARD

Summary judgment is appropriate only if there is no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. See Fed. R. Civ. Proc. 56(c); *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 247, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). In seeking a grant of summary judgment the moving party must identify "those portions of 'the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any' which it believes demonstrate the absence of a genuine issue of material fact." *Celotex Corp. v. Catrett*, 477 U.S. 317, 323, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986) (quoting Fed. R. Civ. Proc. 56(c)). This initial burden may be satisfied by presenting specific evidence on a particular issue or by pointing out "an absence of evidence to support the non-moving party's case." *Celotex*, 477 U.S. at 325. Once the movant has met this burden, the non-moving party cannot simply rest on the allegations in the pleadings, but "must set forth specific facts showing that there is a genuine issue for trial." Fed. R. Civ. Proc. 56(e). A "genuine issue" in the context of a motion for summary judgment is not simply a "metaphysical doubt as to the material facts," *Matsushita Elec. Indus. Co., Ltd. v. Zenith Radio Corp.*, 475 U.S. 574, 586, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986); rather, "[a] genuine issue exists when the evidence is such that a reasonable jury could find for the non-movant." *Buscaglia v. United States*, 25 F.3d 530, 534 (7th Cir. 1994). When reviewing the record we

must draw all reasonable inferences in favor of the non-movant; however, "we are not required to draw every conceivable inference from the record – only those inferences that are reasonable." *Bank Leumi Le-Israel, B.M. v. Lee*, 928 F.2d 232, 236 (7th Cir. 1991).

When parties file cross motions for summary judgment, each motion must be assessed independently, and denial of one does not necessitate the grant of the other. *M. Snower & Co. v. United States*, 140 F.2d 367, 369 (7th Cir. 1944). Rather, each motion evidences only that the movant believes it is entitled to judgment as a matter of law on the issues within its motion and that trial is the appropriate course of action if the court disagrees with that assessment. *Miller v. LeSea Broadcasting, Inc.*, 87 F.3d 224, 230 (7th Cir. 1996). With these principles in mind, we turn to the parties' motions.

DISCUSSION

The legal term for a mutual fund such as those involved in this case is an "open-end management company." See 15 U.S.C. §§ 80a-4, 80a-5. The company operates by combining money from many separate investors and then invests the whole in a portfolio consisting of stocks, bonds, and the like. See http://www.sec.gov/investor/pubs/inwsmf.htm. Shareholders are removed from the actual investment process, creating potential for self-dealing and abuse by investment advisors. To protect investors' interests and avert some of the abuses that were inherent in the industry, Congress passed the Investment Company Act ("ICA"). 15 U.S.C. § 80a-1 *et seq.*; see *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 742 (7th Cir. 2002).

The ICA is a complex statutory scheme. One of its protections is the requirement that investment companies be governed by boards of trustees, 40% of whom are not "interested persons" as defined by the ICA. See 15 U.S.C. §§ 80a-2(19), 80a-10, 80a-15(c). The board, on behalf of the shareholders and in their best interests, negotiates the compensation to be paid to the advisers, who actually run the fund. 15 U.S.C. § 80a-15(c). As part of this process, the board must request information that will allow it to evaluate the terms of the advisory contract, and the adviser must supply the requested information. *Id.* Once the contracts are approved, as stated above, § 36(b) imposes a fiduciary duty on advisers with respect to the compensation they receive. 15 U.S.C. § 80a-35(b). The statute does not delineate the specific boundaries of the fiduciary duty it imposes on investment advisors, but both the legislative history and the prevailing case law agree that it is significantly more circumscribed than the duty that a common-law fiduciary would owe to a beneficiary. See, e.g., *Green*, 295 F.3d at 742-43; *Green v. Fund Asset Management*, 286 F.3d 682, 685 (3d Cir. 2002); *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 329 (4th Cir. 2001).

A. Plaintiffs' Motion for Summary Judgment

As stated above, Plaintiffs' complaint is couched exclusively in terms of alleged violations of § 36(b), predicated on the fees the Funds paid to Harris. Echoing this focus, Plaintiffs' motion for summary judgment specifically disavows any intention to bring a cause of action directly under any section of the ICA other than § 36(b). The Seventh Circuit has not considered a case of an alleged § 36(b) violation in the context of an open-end fund; the leading case involved a closed-end, tax-exempt leveraged fund

that invested in tax-free municipal bonds. *Green*, 295 F.3d at 740. Unlike their open-end counterparts, closed-end investment companies have "fixed capitalization and may sell only the number of shares of its own stock as originally authorized." *Id.* at 740 n.1. Securities are not redeemed at the shareholder's option, and shares are traded on a secondary market. *Id.* Closed-end funds can use leverage to increase their income stream by selling shares of preferred stock. *Id.* The compensation paid to advisers increases as the degree of leverage increases, but the interests of the shareholders are not always best served by increased amounts of leverage. See *id.* at 740-42. In *Green*, the plaintiffs alleged that the mere existence of this relationship between the amount of leverage and the advisers' compensation created an impermissible incentive for the advisers to disregard the shareholders' interests in favor of their own, thus violating the fiduciary duty owed under § 36(b).

The appellate court noted that the statute does not explain the exact meaning of the fiduciary duty beyond stating that one exists. *Id.* at 742. After examining the legislative history of § 36(b) and how other circuits had interpreted it, the court concluded that the duty was much narrower than a common-law fiduciary duty. *Id.* at 743. The panel did not agree with other circuits that had decided that liability would lie under § 36(b) only if an adviser charged an excessive fee, but it took pains to indicate that the scope of the duty was only "slightly" more broad than that. *Id.* at 743 n.8. To illustrate the limits of the court's circumscribed view of potential scenarios leading to liability, the court hypothesized that a clear abuse of the potential conflict of interest for an adviser of a closed-end fund, though "improbable,"

could violate the § 36(b) duty. *Id.* at 743 n.8. Looking to the situation actually set forth, however, the court concluded that because the advisers did not put their interests above those of the shareholders with respect to leveraging decisions, the mere potential for them to do so did not run afoul of § 36(b). *Id.* at 742, 744. Thus, though the Seventh Circuit has not specifically demarcated the outer reaches of the § 36(b) duty, there is no question that the field of behavior the section governs is small and specific. See *id.* at 743 n.8.

Despite Plaintiffs' assertions that their motion is based only in § 36(b), the arguments they present focus on conduct of parties other than Harris or actions of Harris other than receipt of compensation. The first contends that Morgenstern received deferred compensation from Harris, rendering him an interested party in Harris and making him ineligible to vote on approval of any fee agreements. The second urges that the trustees were so enmeshed with Harris through social and professional relationships that they could not have exercised independent judgment in assessing the fees that Harris proposed. The third claims that Harris's failure to disclose Morgenstern's compensation and his relationships with other members of the board in SEC filings voids the fee agreement for the applicable time period. In other words, the motion asserts violations of portions of the ICA other than § 36(b). Whether the conduct described violates other sections of the ICA is of no moment, as those sections do not include a private right of action and Plaintiffs have asserted that they only contend that the offending actions violate § 36(b). Because the actions taken do not add up to an actual conflict of interest that manifested in the detriment of share-

holders, the behavior with which Plaintiffs take issue does not fall within the scope of the § 36(b) duty described in Green.

Even if there were some basis to consider these claims within the scope of the § 36(b) duty, Plaintiffs' argument would still not result in summary judgment in their favor. First, the ICA requires that no more than 60% of the members of the Funds' board of trustees could be parties interested in Harris. Even assuming Morgenstern's deferred compensation made him interested for purposes of the ICA, that would bring the percentage of interested board members at worst to 30%, well within the amount allowed by statute. Thus, Morgenstern's status as an interested or disinterested trustee has no effect on the statutory validity of the actions the board took in this case.

On the second point, Plaintiffs in essence contend that Wilner, Ruder, Rotter, Friduss, Reich, Hayden, or Maki were "interested" parties, rendering them "affiliated" with Harris, because they were so closely connected to Harris that Harris would have known that the agreed-upon compensation was not the product of an objective bargaining process. See *Migdal*, 248 F.3d at 329. There are several ways a party can be considered affiliated with an adviser, but for this case, the directors would be affiliated if they can be considered "controlled" by a person affiliated with Harris. See *id.* Though the statute's definition of control is couched in terms of control over a company or fund, 15 U.S.C. § 80a-2(a)(9), Plaintiffs appear to assert that Morgenstern exercised "control" over other members of the board via his social and other business relationships with them. However, other than their relationships with Morgenstern, there is no allegation that Wilner, Ruder, Rotter, Friduss,

Reich, Hayden, or Maki was "affiliated" with Harris. Even drawing all inferences in favor of the Plaintiffs, which is a more favorable consideration than that man for a motion of this sort, the most that Plaintiffs have described is a situation that where people who were financially dependent on Harris had the ability to influence some of the board members to subjugate the shareholders' interest to Harris's interest. *Green* makes clear that the potential for a conflict of interest is not enough; only an actual conflict that resulted in an identified effect on shareholders' interests will suffice. *Green*, 295 F.3d at 744. Plaintiffs have not shown that Harris attempted to exercise that influence, let alone that it would have been enough to make it impossible for the trustees to act without compromising the shareholders.

Finally, with respect to the third argument, Plaintiffs do not explain how the disclosure of Morgenstern's deferred compensation in a filing to the SEC relates to the § 36(b) fiduciary duty with respect to compensation received by Harris. There is no evidence that any failure to disclose impacted the amount of fees Harris was paid. To sweep this conduct into the ambit of § 36(b) would directly contradict the universal view that the fiduciary duty it sets out is both narrow and limited. See, e.g., *Green*, 295 F.3d at 743 n.8; *Green*, 286 F.3d at 684-85; *Migdal*, 248 F.3d at 329.

In sum, Plaintiffs have not established any basis for us to conclude that they are entitled to judgment as a matter of law on the issues presented in their motion. As a result, Plaintiffs' cross motion for summary judgment is denied.

B. Harris's Motion for Summary Judgment

Unlike Plaintiffs' motion, Harris's motion focuses on the assertions within the complaint, which are grounded in a contention that Harris breached its § 36(b) fiduciary duty by receiving excessive fees for the advisory services it provided to the Funds. The prevailing standard for assessing such claims was first established in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2nd Cir. 1982). *Gartenberg* involved an open-end company for which Merrill Lynch provided investment advice as well as administrative and other services. *Id.* at 925, 926. It allowed customers to order immediate purchase or redemption of shares, and 30,000 such orders were processed in an average day. *Id.* at 926. A combination of favorable attributes led to significant investment in the fund, boosting its size from $288 million to over $19 billion in a 52-month period. *Id.* at 926. The fund had over 1.1 million individual and institutional investors. *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 528 F.Supp. 1038, 1039 (S.D.N.Y. 1981). Two of the fund's investors sued, arguing that the negotiated fee percentage had become unreasonable and that Merrill Lynch's continued receipt of fees calculated using that percentage violated its fiduciary duty under § 36(b). *Gartenberg*, 694 F.2d at 928.

After a bench trial, the district judge found for Merrill Lynch, relying primarily on the fact that the fees charged to the fund were comparable to those charged to other money market funds. *Id.* at 929. Rather than considering that fact essentially dispositive, the Second Circuit emphasized that the district court should instead consider all facts pertinent to the amount of fees paid had to be considered. *Id.*

929. Only by examining all factors bearing upon whether an adviser's compensation was within the range that could be expected to result from arm's-length bargaining needed to be considered when assessing a claimed breach of fiduciary duty. *Id.* at 928-29. In the specific context presented in *Gartenberg*, the court determined that the facts pertinent to the question of the disproportionality of the fees included not only the comparability of fees but also the cost to the adviser to provide services to the fund; the nature and quality of the services that are provided, including the fund's performance history; whether and to what extent the adviser realizes economies of scale as the fund's assets increase; the volume of orders from the fund's investors that need to be processed (a consideration that played heavily into the district court's decision); and the conduct of, expertise of, and level of information possessed by the trustees charged with approving the fee at the outset. *Id.* at 930. After examining the impact of each of these aspects of the parties' relationship, the Second Circuit concluded that the compensation Merrill Lynch received from the fund, though undoubtedly a sizeable amount, was not so disproportionate to the value of the services it rendered that they could not have been the product of arms-length bargaining. *Id.* at 933.

Plaintiffs argue that *Green* rejected the standard set out in *Gartenberg* standard and thus that it should not apply in this case. We disagree with their assessment of *Green*. The Seventh Circuit took the view that § 36(b) encompassed breaches of duty other than receipt of wildly disproportionate advisory fees, but the court did not state that the proper analysis when the alleged breach of duty involves excessive

fees would be other than the formulation advanced in *Gartenberg*. See 295 F.3d at 743 n.8. Instead, *Green* discussed what other conduct could violate § 36(b) and how that should be treated. The different nature of the claim involved in *Green* counsels against a conclusion that the Seventh Circuit would not apply the *Gartenberg* standard in an excessive fees case such as this one. Accordingly, we accept *Gartenberg* as supplying the applicable framework for our analysis.

In considering this motion, then, we must examine whether there is a triable issue of fact on the question of whether the fees charged to the Funds were so disproportionately large that they could not have been the result of arm's-length bargaining between Harris and the board. See *Gartenberg*, 694 F.2d at 928. In performing this examination, our consideration is confined to the fees charged between August 2003 and August 2004 and the advisory contracts underlying those fees. As *Gartenberg* makes clear, the fees charged in the mutual fund industry are the product of a negotiation, wherein both sides engage in a process of taking some things while giving up others. *Id.* Consequently, there is no single outcome that can be expected; instead, there is a range of acceptable results.

According to Harris's motion, the fees in this case fall within an acceptable range for four reasons. First, the advisory fees were in line with those charged by 10 (for Oakmark) or 11 (for Equity and Global) other similar funds managed by other companies. Second, Harris provided information to the trustees about each Fund and its operation, and the trustees then approved the fee schedule. Third, the schedule included breakpoints that applied to all or some of the fees incurred during the damages period, and

those breakpoints in part resulted from the negotiation efforts of the trustees. Lastly, the Funds performed well, relatively speaking, during the damages period.

In response to Harris's first point, Plaintiffs do not dispute that Harris's fees were comparable to those charged by other similar funds. Instead, they insist that we must compare Harris's fees not to those charged to funds run by managers other than Harris but rather to those charged to institutional clients. According to Plaintiffs, that comparison is the more meaningful because institutional clients received the same research and investment services that the Funds did. We cannot, for purposes of this motion, disregard this comparison, as Defendants urge us. However, making all inferences in favor of the Plaintiffs does not mean we must ignore the undisputed fact that shareholders in at least nine other mutual funds investors were paying fees at the same level that the Funds were. Even assuming for the mere sake of comparison that the services Harris's institutional clients received were indistinguishable from those the Funds received, the amounts paid by different parties establish a range of prices that investors were willing to pay. The range extended from a low-end figure below what the institutional clients were paying and a high-end figure beyond the fees that other mutual fund clients paid. Harris's fees fell within this range, thus preventing a conclusion that the amount of fees indicates that self-dealing was afoot.

With regard to the fact that the fee agreement went through a process of review that ultimately led to its approval by the board, Plaintiffs contend that the board members were hopelessly conflicted,

rendering their review meaningless. For the reasons set forth in our consideration of Plaintiffs' cross motion, we disagree with their conclusions on this point. Consequently, we have no reason to discount the notion that the shareholders' interests were represented at the negotiating table by a group of people who were capable of giving those interests primacy. Whether they were able to negotiate the best possible arrangement does not factor into our analysis; the only question we need consider is whether they could have agreed to the fee schedule in the advisory contracts after engaging in good-faith bargaining. The evidence the parties have provided indicate that the board as a whole was operating without any conflict that would prevent it from engaging in arm's-length negotiations with Harris.

Moving to the third of Harris's points, Plaintiffs contend that the breakpoints were not set in relation to any analysis of the savings achieved from economies of scale. Instead, they claim, Harris set the points at a level so high that little if any savings would be passed on to shareholders. Interestingly, Plaintiffs do not provide any evidence of what savings were gained from economies of scale. There can be no doubt that, if breakpoints had been set at a lower level, Plaintiffs could have paid lower fees. However, as was true for the second of Harris's points, discussed above, whether breakpoints could have been set at a lower level is not the issue. The issue is whether the board could have agreed to the breakpoints being set at those levels after engaging in good-faith negotiations. There is no indication that they could not, and the fact that the level of breakpoints was comparable to what shareholders in

other mutual funds had accepted indicates that they could result from arm's-length negotiation.

On the point of performance, Plaintiffs do not dispute the contentions Harris makes about the returns the Funds produced up until March 2004. Instead, they insist that we should look instead at the performance levels that took place after that point in time. However, how the Funds performed after the damages period is not relevant to the quality of services rendered before that time.

To counter the effect of the points Harris have raised, Plaintiffs must demonstrate that the flaws they find in what transpired would have made a legally significant difference. Rather than doing so, Plaintiffs tell an elaborate story of what they believe should have transpired between the Funds and Harris in order to produce a deal that would ultimately be more advantageous to the Plaintiffs than the arrangement that was reached. However, the evidence they have adduced establishes at most that others paid different amounts for similar services. It does not allow a reasonable inference that the difference was enough to put the amount charged outside of the range that could be expected to result from arm's-length bargaining. Section 36(b) does not create a duty that advisers receive the lowest possible fee amount of compensation for the services they provide. Whether the Funds could have gotten more for their money from Harris is irrelevant. What matters is whether there is a fundamental disconnect between what the Funds paid and what the services were worth; on this score Plaintiffs have not set forth an issue of fact that, if resolved in their favor, could lead to a finding that Harris had breached its § 36(b) duty. As a result, Harris is entitled to summary judgment

in its favor with respect to the fees the Funds paid from August 2003 to August 2004.

CONCLUSION

Based on the foregoing, Plaintiffs' motion for summary judgment is denied. Harris's motion for summary judgment is granted on the entirety of Plaintiffs' complaint.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 07-1624

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Plaintiffs-Appellants,

v.

HARRIS ASSOCIATES L.P.,
Defendant-Appellee.

Aug. 8, 2008

On Petition for Rehearing and Rehearing En Banc

Before EASTERBROOK, Chief Judge, and KANNE and EVANS, Circuit Judges.

PER CURIAM.

The panel has voted unanimously to deny the petition for rehearing. A judge in active service called for a vote on the suggestion for rehearing en banc. A majority did not favor rehearing en banc, and the petition therefore is denied. Circuit Judge Ripple did not participate in the cónsideration or decision of this case.

POSNER, Circuit Judge, with whom Circuit Judges ROVNER, WOOD, WILLIAMS, and TINDER join, dissenting from denial of rehearing en banc.

This case merits the attention of the full court. The panel rejected the approach taken by the Second Circuit in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), to deciding whether a mutual fund adviser has breached his fiduciary duty to the fund, the duty created by section 36(b) of the Investment Company Act, 15 U.S.C. §§ 80a-1 *et seq.* *Gartenberg* permits a court to consider, as a factor in determining such a breach, whether the fee is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." 694 F.2d at 928. The panel opinion states that it "now disapprove[s] the *Gartenberg* approach. . . . A fiduciary must make full disclosure, and play no tricks but is not subject to a cap on compensation." *Jones v. Harris Associates L.P.*, 527 F.3d 627, 632 (7th Cir. 2008).

The opinion says that this court had previously suggested that the *Gartenberg* approach "is wanting." *Id.* It cites *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 743 n.8 (7th Cir. 2002), for this proposition, but neither in footnote 8 nor elsewhere in that opinion is there any suggestion that *Gartenberg*'s treatment of the issue of excessive fees is incorrect; *Green* was not an excessive-fee case. The panel cites another *Green* opinion, *Green v. Fund Asset Management, L.P.*, 286 F.3d 682 (3d Cir. 2002), as suggesting disagreement with *Gartenberg*, but again the amount of compensation was not at issue.

Jones is the only appellate opinion noted in Westlaw as disagreeing with *Gartenberg*; there is a slew

of positive citations. See, e.g., *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 326-27 (4th Cir. 2001); *In re Salomon Smith Barney Mutual Fund Fees Litigation*, 528 F. Supp. 2d 332, 336-37 (S.D.N.Y. 2007); *Gallus v. Ameriprise Financial, Inc.*, 497 F. Supp. 2d 974, 979 (D. Minn. 2007); *Sins v. Janus Capital Management, LLC*, 2006 WL 3746130, at *2 (D. Colo. Dec. 15, 2006); *Siemers v. Wells Fargo & Co.*, 2006 WL 2355411, at *15-16 (N.D. Cal. Aug. 14, 2006); *Hunt v. Invesco Funds Group, Inc.*, 2006 WL 1581846, at *2 (S.D. Tex. June 5, 2006); *Stegall v. Ladner*, 394 F. Supp. 2d 358, 373-74 (D. Mass. 2005); *Becherer v. Burt*, 2003 WL 24260305, at *2 (S.D. Ill. Mar. 6, 2003); *Millenco L.P. v. MEVC Advisors, Inc.*, 2002 WL 31051604, at *3 (D. Del. Aug. 21, 2002). The Coates and Hubbard article that the panel cites, John C. Coates & R. Glenn Hubbard, "Competition in the Mutual Fund Industry: Evidence and Implications for Policy," 33 *J. Corp. L.* 151 (2007), expressly approves *Gartenberg*, while seeking to fine tune judicial interpretations of some *Gartenberg* dicta. In the section of the article captioned "Refinements to *Gartenberg*," the authors state that "radical shifts in existing law, or for sweeping new laws and regulations, are unwise on the ground that the case has not been made that the existing framework for regulation of funds and advisory fees is intrinsically flawed." *Id.* at 213. It's not as if *Gartenberg* has proved to be too hard on fund advisers. "Subsequent litigation [after *Gartenberg*] in excessive fee cases has resulted almost uniformly in judgments for the defendants . . . although there have been some notable settlements wherein defendants have agreed to prospective reduction in the fee schedule." James D. Cox et al., *Securities Regulation: Cases and Materials* 1211 (3d

ed. 2001); see also James D. Cox & John W. Payne, "Mutual Fund Expense Disclosures: A Behavioral Perspective," 83 *Wash. U.L.Q.* 907, 923 (2005).

The panel bases its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation. See, e.g., Lucian Bebchuk & Jesse Fried, *Pay without Performance: The Unfilfilled Promise of Executive Compensation* 23-44 (2004); Charles A. O'Reilly III & Brian G.M. Main, "It's More Than Simple Economics," 36 *Organizational Dynamics* 1 (2007); Ivan E. Brick, Oded Palmon & John K. Wald, "CEO Compensation, Director Compensation, and Firm Performance: Evidence of Cronyism?," 12 *J. Corp. Finance* 403 (2006); Arthur Levitt, Jr., "Corporate Culture and the Problem of Executive Compensation," 30 *J. Corp. Law* 749, 750 (2005); Gary Wilson, "How to Rein in the Imperial CEO," *Wall St. J.*, July 9, 2008, p. A15; Joann S. Lublin, "Boards Flex Their Pay Muscles: Directors Are Increasingly Exercising More Clout in Setting CEO Compensation; and in Some Cases, the Boss Is Actually Feeling a Little Pain," *Wall St. J.*, Apr. 14, 2008, p. R1; Ben Stein, "In the Boardroom, Every Back Gets Scratched," *N.Y. Times*, Apr. 6, 2008, p. B9. Directors are often CEOs of other companies and naturally think that CEOs should be well paid. And often they are picked by the CEO. Compensation consulting firms, which provide cover for generous compensation packages voted by boards of directors, have a conflict of interest because they are paid not only for their compensation advice but for other services to the firm – services for which

they are hired by the officers whose compensation they advised on. Bebchuk & Fried, *supra*, at 37-39; Gretchen Morgenson, "How Big a Payday for the Pay Consultants?," *N.Y. Times*, June 22, 2008, p. B1; Neil Weinberg, Michael Maiello & David K. Randall, "Paying for Failure," *Forbes*, May 19, 2008, p. 114; Joann S. Lublin, "Conflict Concerns Benefit Independent Pay Advisors," *Wall St. J.*, Dec. 10, 2007, p. B3; Warren E. Buffet, "Letter to the Shareholders of Berkshire Hathaway, Inc.," Feb. 27, 2004, p. 8, www.berkshirehathaway.com/letters/2003ltr.pdf (visited July 28, 2008).

Competition in product and capital markets can't be counted on to solve the problem because the same structure of incentives operates on all large corporations and similar entities, including mutual funds. Mutual funds are a component of the financial services industry, where abuses have been rampant, as is more evident now than it was when Coates and Hubbard wrote their article. A business school professor at Northwestern University recently observed that "business connections can mitigate agency conflicts by facilitating efficient information transfers, but can also be channels for inefficient favoritism." She found "evidence that connections among agents in [the mutual fund industry] foster favoritism, to the detriment of investors. Fund directors and advisory firms that manage the funds hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely. These findings support recent calls for more disclosure regarding the negotiation of advisory contracts by fund boards." Camelia M. Kuhnen, "Social Networks, Corporate Governance

and Contracting in the Mutual Fund Industry" (Mar. 1, 2007), http://ssrn.com/abstract=849705 (visited July 28, 2008). The SEC's Office of Economic Analysis (the principal adviser to the SEC on the economic aspects of regulatory issues) believes that mutual fund "boards with a greater proportion of independent directors are more likely to negotiate and approve lower fees, merge poorly performing funds more quickly or provide greater investor protection from late-trading and market timing," although "broad cross-sectional analysis reveals little consistent evidence that board composition is related to lower fees and higher returns for fund shareholders." "OEA Memorandum: Literature Review on Independent Mutual Fund Chairs and Directors," Dec. 29, 2006, www.404.gov/rules/proposed/s70304/oeamemo122906-litreview.pdf (visited July 28, 2008).

A particular concern in this case is the adviser's charging its captive funds more than twice what it charges independent funds. According to the figures in the panel opinion, the captives are charged one percent of the first $2 billion in assets while the independents are charged roughly one-half of one percent for the first $500 million and roughly one-third of one percent for everything above. The panel opinion throws out some suggestions on why this difference may be justified, but the suggestions are offered purely as speculation, rather than anything having an evidentiary or empirical basis. And there is no doubt that the captive funds are indeed captive. The Oakmark-Harris relationship matches the arrangement described in the Senate Report accompanying § 36(b): a fund "organized by its investment adviser which provides it with almost all management services." S.Rep. No. 184, 91st Cong., 1st Sess. 41 (1969),

quoted in *Green v. Fund Asset Management, L.P.*, *supra*, 286 F.3d at 685. Financial managers from Harris founded the Oakmark family of funds in 1991, and each year since then the Oakmark Board of Trustees has reselected Harris as the fund's adviser. Harris manages the entire Oakmark portfolio, which consists of seven funds. The Oakmark prospectus describes the relationship this way: "Subject to the overall authority of the board of trustees, [Harris Associates] furnishes continuous investment supervision and management to the Funds and also furnishes office space, equipment, and management personnel." The Oakmark Funds, "Prospectus," Jan. 28, 2008, p. 36, www.oakmark.com/fundlit/literature.asp?selected=Prospectus# (visited July 28, 2008). Recall Professor Kuhnen's observation that "when directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely."

The panel opinion says that the fact "that mutual funds are 'captives' of investment advisers does not curtail this competition. An adviser can't make money from its captive fund if high fees drive investors away." 527 F.3d at 632. That's true; but will high fees drive investors away? "[T]he chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arm's-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from arm's-length bargaining nor from prices that approximate those that arm's-length bargaining would yield were it the norm." John P. Freeman & Stewart L. Brown,

"Mutual Fund Advisory Fees: The Cost of Conflicts of Interest," 26 *J. Corp. L.* 609, 634 (2001).

The panel opinion acknowledges that the level of compensation of trustees could be "so unusual that a court will infer that deceit must have occurred, or that the persons responsible for [the] decision have abdicated." 527 F.3d at 632. Compensation that is "so unusual" might not seem to differ materially from compensation that is "so disproportionately large." But although one industry commentator has suggested that "courts may . . . conclude that in fact what the Court of Appeals has done [in *Jones*] is merely articulate the *Gartenberg* standard in a different way," "Seventh Circuit 'Disapproves' Gartenberg, But Is This New Approach Fundamentally Different?," May 27, 2008, www.bingham.com/Media.aspx?MediaID=7004 (visited July 28, 2008), this misses an important difference between the *Gartenberg* approach and the panel's approach. The panel's "so unusual" standard is to be applied solely by comparing the adviser's fee with the fees charged by other mutual fund advisers. *Gartenberg*'s "so disproportionately large" standard is rightly not so limited. The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor. And in this case there was an alternative comparison, rejected by the panel on the basis of airy speculation – comparison of the fees that Harris charges independent funds with the much higher fees that it charges the funds it controls.

The panel opinion points out that courts do not review corporate salaries for excessiveness. That misses the point, which is that unreasonable com-

pensation can be evidence of a breach of fiduciary duty.

The opinion is recognized to have created a circuit split, although the panel did not acknowledge this or circulate its opinion to the full court in advance of publication, as is required when a panel creates a circuit split. See, e.g., "Fund Alert: Seventh Circuit Rejects *Gartenberg* Approach to Determining the Appropriateness of Mutual Fund Management Fees," May 2008, www.stradley.com/newsletters.php?action=view&id=347; "Investment Management Alert: Seventh Circuit Court of Appeals Rejects *Gartenberg*," June 2, 2008, www.drinkerbiddle.com/files/Publication/f74b9bc2-9376-4b60-b732-0242868a873c/Presentation/PublicationAttachment/be9e677f-8b35-440a-8b53-022caedb13e0/Gartenberg.pdf; "Email Alerts: It's Too Early to Disregard the *Gartenberg* Factors During Advisory Fee Renewals," May 27, 2008, www.wilmerhale.com/publications/whPubsDetail.aspx?publication=8329; "Appeals Court Rejects Mutual Fund Excessive Fee Claims, Adopting New Standard for Evaluation of Fees," May 20, 2008, www.ropesgray.com/litigationalert/?PublicationTypes=0c16874b-f94e-4696-b607-de259b87a13f; "The Future of *Gartenberg*: A New Approach in Evaluating Investment Advisor Fees," May 2008, www.paulhastings.com/assets/publications/919.pdf?wt.mc_ID=919.pdf. (All these web sites were visited on July 28, 2008.)

The *outcome* of this case may be correct. The panel opinion gives some reasons why, though one of them is weak in its unelaborated form: that the funds managed by Harris have grown faster than the industry norm. One would need to know over what period they had grown faster to know whether other than random factors were at work. But the creation

of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel's analysis warrant our hearing the case en banc.

STATUTORY PROVISIONS INVOLVED

The Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, provides in relevant part as follows:

15 U.S.C. § 80a-2(a)(19) provides:

§ 80a-2. Definitions; applicability; rulemaking considerations

(a) Definitions

When used in this subchapter, unless the context otherwise requires –

* * *

(19) "Interested person" of another person means –

(A) when used with respect to an investment company –

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company,

(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio

transactions for, engaged in any principal transactions with, or distributed shares for –

(I) the investment company;

(II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or

(III) any account over which the investment company's investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to –

(I) the investment company;

(II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or

(III) any account for which the investment company's investment adviser has borrowing authority,[1]

(vii) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed

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[1] So in original. Probably should be followed by the word "and".

fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company: *Provided*, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

(B) when used with respect to an investment adviser of or principal underwriter for any investment company –

(i) any affiliated person of such investment adviser or principal underwriter,

(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

(iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser of principal underwriter or by a controlling person or such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter.

(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for –

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

(III) any account over which the investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to –

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment

adviser or principal underwriter serves as such; or

(III) any account for which the investment adviser has borrowing authority,[1]

(vii) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this paragraph (19), "member of the immediate family" means any parent, spouse of a parent, child, spouse of a child, spouse, brother, or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagraph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this subchapter or for any other purpose for any period prior to the effective date of such order.

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[1] So in original. Probably should be followed by the word "and".

15 U.S.C. § 80a-10 provides:

§ 80a-10. Affiliations or interest of directors, officers, and employees

(a) Interested persons of company who may serve on board of directors

No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

(b) Employment and use of directors, officers, etc., as regular broker, principal underwriter, or investment banker

No registered investment company shall –

(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an interested person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or interested persons of any of such principal underwriters; or

(3) have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affili-

ated persons of any investment banker. For the purposes of this paragraph, a person shall not be deemed an affiliated person of an investment banker solely by reason of the fact that he is an affiliated person of a company of the character described in section 80a-12(d)(3)(A) and (B) of this title.

(c) Officers, directors, or employees of one bank or bank holding company as majority of board of directors of company; exceptions

No registered investment company shall have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank (together with its affiliates and subsidiaries) or any one bank holding company (together with its affiliates and subsidiaries) (as such terms are defined in section 1841 of title 12) or any one savings and loan holding company, together with its affiliates and subsidiaries (as such terms are defined in section 1467a of title 12), except that, if on March 15, 1940, any registered investment company had a majority of its directors consisting of persons who are directors, officers, or employees of any one bank, such company may continue to have the same percentage of its board of directors consisting of persons who are directors, officers, or employees of such bank.

(d) Exception to limitation of number of interested persons who may serve on board of directors

Notwithstanding subsections (a) and (b)(2) of this section, a registered investment company may have a board of directors all the members of which, except one, are interested persons of the investment adviser of such company, or are officers or employees of such company, if –

(1) such investment company is an open-end company;

(2) such investment adviser is registered under subchapter II of this chapter and is engaged principally in the business of rendering investment supervisory services as defined in subchapter II;

(3) no sales load is charged on securities issued by such investment company;

(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

(8) such investment company has only one class of securities outstanding, each unit of which has equal voting rights with every other unit.

(e) Death, disqualification, or resignation of directors as suspension of limitation provisions

If by reason of the death, disqualification, or bona fide resignation of any director or directors, the requirements of the foregoing provisions of this section or of section 80a-15(f)(1) of this title in respect of directors shall not be met by a registered investment company, the operation of such provision shall be suspended as to such registered company –

(1) for a period of thirty days if the vacancy or vacancies may be filled by action of the board of directors;

(2) for a period of sixty days if a vote of stockholders is required to fill the vacancy or vacancies; or

(3) for such longer period as the Commission may prescribe, by rules and regulations upon its own motion or by order upon application, as not inconsistent with the protection of investors.

(f) Officer, director, etc., of company acting as principal underwriter of security acquired by company

No registered investment company shall knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security (except a security of which such company is the issuer) a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of such registered company, or is a person (other than a company of the character described in section 80a-12(d)(3)(A) and (B) of this title) of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person, unless in acquiring such security such registered company is itself acting as a

principal underwriter for the issuer. The Commission, by rules and regulations upon its own motion or by order upon application, may conditionally or unconditionally exempt any transaction or classes of transactions from any of the provisions of this subsection, if and to the extent that such exemption is consistent with the protection of investors.

(g) Advisory boards; restrictions on membership

In the case of a registered investment company which has an advisory board, such board, as a distinct entity, shall be subject to the same restrictions as to its membership as are imposed upon a board of directors by this section.

(h) Application of section to unincorporated registered management companies

In the case of a registered management company which is an unincorporated company not having a board of directors, the provisions of this section shall apply as follows:

(1) the provisions of subsection (a) of this section, as modified by subsection (e) of this section, shall apply to the board of directors of the depositor of such company;

(2) the provisions of subsections (b) and (c) of this section, as modified by subsection (e) of this section, shall apply to the board of directors of the depositor and of every investment adviser of such company; and

(3) the provisions of subsection (f) of this section shall apply to purchases and other acquisitions for the account of such company of securities a principal underwriter of which is the depositor or an investment adviser of such company, or an affiliated person of such depositor or investment adviser.

15 U.S.C. § 80a-15 provides:

§ 80a-15. Contracts of advisers and underwriters

(a) Written contract to serve or act as investment adviser; contents

It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and –

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment.

(b) Written contract with company for sale by principal underwriter of security of which company is issuer; contents

It shall be unlawful for any principal underwriter for a registered open-end company to offer for sale,

sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract –

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment.

(c) Approval of contract to undertake service as investment adviser or principal underwriter by majority of noninterested directors

In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in

connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

(d) Equivalent of vote of majority of outstanding voting securities in case of common-law trust

In the case of a common-law trust of the character described in section 80a-16(c) of this title, either written approval by holders of a majority of the outstanding shares of beneficial interest or the vote of a majority of such outstanding shares cast in person or by proxy at a meeting called for the purpose shall for the purposes of this section be deemed the equivalent of the vote of a majority of the outstanding voting securities, and the provisions of paragraph (42) of section 80a-2(a) of this title as to a majority shall be applicable to the vote cast at such a meeting.

(e) Exemption of advisory boards or members from provisions of this section

Nothing contained in this section shall be deemed to require or contemplate any action by an advisory board of any registered company or by any of the members of such a board.

(f) Receipt of benefits by investment adviser from sale of securities or other interest in such investment adviser resulting in assignment of investment advisory contract

(1) An investment adviser, or a corporate trustee performing the functions of an investment adviser, of a registered investment company or an affiliated person of such investment adviser or corporate trustee may receive any amount or benefit in con-

nection with a sale of securities of, or a sale of any other interest in, such investment adviser or corporate trustee which results in an assignment of an investment advisory contract with such company or the change in control of or identity of such corporate trustee, if –

(A) for a period of three years after the time of such action, at least 75 per centum of the members of the board of directors of such registered company or such corporate trustee (or successor thereto, by reorganization or otherwise) are not (i) interested persons of the investment adviser of such company or such corporate trustee, or (ii) interested persons of the predecessor investment adviser or such corporate trustee; and

(B) there is not imposed an unfair burden on such company as a result of such transaction or any express or implied terms, conditions, or understandings applicable thereto.

(2)(A) For the purpose of paragraph (1)(A) of this subsection, interested persons of a corporate trustee shall be determined in accordance with section 80a-2(a)(19)(B) of this title: *Provided*, That no person shall be deemed to be an interested person of a corporate trustee solely by reason of (i) his being a member of its board of directors or advisory board or (ii) his membership in the immediate family of any person specified in clause (i) of this subparagraph.

(B) For the purpose of paragraph (1)(B) of this subsection, an unfair burden on a registered investment company includes any arrangement, during the two-year period after the date on which any such transaction occurs, whereby the investment adviser or corporate trustee or predecessor or

successor investment advisers or corporate trustee or any interested person of any such adviser or any such corporate trustee receives or is entitled to receive any compensation directly or indirectly (i) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of such company, other than bona fide ordinary compensation as principal underwriter for such company, or (ii) from such company or its security holders for other than bona fide investment advisory or other services.

(3) If –

(A) an assignment of an investment advisory contract with a registered investment company results in a successor investment adviser to such company, or if there is a change in control of or identity of a corporate trustee of a registered investment company, and such adviser or trustee is then an investment adviser or corporate trustee with respect to other assets substantially greater in amount than the amount of assets of such company, or

(B) as a result of a merger of, or a sale of substantially all the assets by, a registered investment company with or to another registered investment company with assets substantially greater in amount, a transaction occurs which would be subject to paragraph (1)(A) of this subsection, such discrepancy in size of assets shall be considered by the Commission in determining whether or to what extent an application under section 80a-6(c) of this title for exemption from the provisions of paragraph (1)(A) of this subsection should be granted.

(4) Paragraph (1)(A) of this subsection shall not apply to a transaction in which a controlling block of outstanding voting securities of an investment adviser to a registered investment company or of a corporate trustee performing the functions of an investment adviser to a registered investment company is –

(A) distributed to the public and in which there is, in fact, no change in the identity of the persons who control such investment adviser or corporate trustee, or

(B) transferred to the investment adviser or the corporate trustee, or an affiliated person or persons of such investment adviser or corporate trustee, or is transferred from the investment adviser or corporate trustee to an affiliated person or persons of the investment adviser or corporate trustee: *Provided*, That (i) each transferee (other than such adviser or trustee) is a natural person and (ii) the transferees (other than such adviser or trustee) owned in the aggregate more than 25 per centum of such voting securities for a period of at least six months prior to such transfer.

15 U.S.C. § 80a-33 provides:

§ 80a-33. Destruction and falsification of reports and records

(a) Willful destruction

It shall be unlawful for any person, except as permitted by rule, regulation, or order of the Commission, willfully to destroy, mutilate, or alter any account, book, or other document the preservation of which has been required pursuant to section 80a-30(a) or 80a-31(c) of this title.

(b) Untrue statements or omissions

It shall be unlawful for any person to make any untrue statement of a material fact in any registration statement, application, report, account, record, or other document filed or transmitted pursuant to this subchapter or the keeping of which is required pursuant to section 80a-30 (a) of this title. It shall be unlawful for any person so filing, transmitting, or keeping any such document to omit to state therein any fact necessary in order to prevent the statements made therein, in the light of the circumstances under which they were made, from being materially misleading. For the purposes of this subsection, any part of any such document which is signed or certified by an accountant or auditor in his capacity as such shall be deemed to be made, filed, transmitted, or kept by such accountant or auditor, as well as by the person filing, transmitting, or keeping the complete document.

15 U.S.C. § 80a-35 provides:

§ 80a-35. Breach of fiduciary duty

(a) Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts –

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

(b) Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such

compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payment received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loads for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction

to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

(c) Corporate or other trustees performing functions of investment advisers

For the purposes of subsections (a) and (b) of this section, the term "investment adviser" includes a corporate or other trustee performing the functions of an investment adviser.

OPPOSITION BRIEF

No. 08-586

Supreme Court, U.S.
FILED
FEB 2 - 2009
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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BRIEF IN OPPOSITION

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QUESTION PRESENTED

Respondent Harris Associates L.P. is the investment adviser to three funds that, during the relevant period, had significantly better returns than competing funds. Notwithstanding that exceptional performance, respondent charged those funds fees that were in line with the prevailing industry rates for its services; it likewise disclosed all relevant facts to the fund trustees responsible for negotiating its compensation. The question presented is:

Whether the district court and court of appeals erred in holding, on summary judgment, that the compensation received was not so unusual or disproportionate as to reflect a "breach of fiduciary duty with respect to the receipt of compensation" within the meaning of Section 36(b) of the Investment Company Act.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, Respondent Harris Associates L.P. ("Harris") states that it is a Delaware limited partnership managed by its general partner, Harris Associates, Inc., which owns 0.33% of the limited partnership interests. Harris Associates, Inc. is a wholly-owned indirect subsidiary of Natixis Global Asset Management, L.P. ("Natixis U.S."). Natixis U.S. owns 99.67% of Harris's limited partnership interests and, through its wholly-owned subsidiary, Natixis Global Asset Management Holdings, LLC, all of the outstanding shares of Harris Associates, Inc. No publicly held corporation owns 10% or more of Harris's stock.

Natixis U.S. is part of Natixis Global Asset Management, an international asset management group based in Paris, France, that is ultimately owned principally, directly or indirectly, by three affiliated French financial services firms: Natixis, an investment banking and financial services firm; the Caisse Nationale des Caisses d'Epargne, a financial institution owned by French regional savings banks known as the Caisses d'Epargne; and the Banque Federale des Banques Populaires, a financial institution owned by regional cooperative banks known as the Banques Populaires. Natixis is a public company whose shares trade on the Euronext Paris exchange.

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BRIEF IN OPPOSITION

STATEMENT

I. STATUTORY BACKGROUND

A. The Investment Company Act

Congress enacted the Investment Company Act of 1940 ("ICA"), 15 U.S.C. §80a-1 *et seq.*, to protect mutual fund investors. A mutual fund is an investment company that pools money from multiple investors for investment in stocks, bonds, or other securities. Typically, a separate company—an investment adviser registered under the ICA's companion statute, the Investment Advisers

Act, 15 U.S.C. §80b-1 *et seq.*—professionally manages the mutual fund's portfolio, selecting investments and supervising the fund's daily operation. Investment advisers often provide services to other entities, such as institutional investors and pension funds. But the services provided to those entities, and the costs of providing them, are often very different. See John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 Iowa J. Corp. L. 151, 185 (2007) ("Significant product and cost differences separate the advising of retail mutual funds and the advising of public pension plans.").

As a matter of industry practice and law, investment advisers and mutual funds are separate. Nonetheless, investment advisers often form mutual funds as vehicles for selling services to the public. See *Daily Income Fund* v. *Fox*, 464 U.S. 523, 536 (1984). Most mutual funds are "formed, sold, and managed" by a "separately owned and operated" investment adviser that "selects the funds' investments and operates their business." *Burks* v. *Lasker*, 441 U.S. 471, 481 (1979) (quoting S. Rep. No. 91-184, at 5 (1969)).

The ICA protects mutual-fund investors by requiring that the mutual fund be independent from its investment adviser on a variety of issues, *Burks*, 441 U.S. at 482; 15 U.S.C. §§80a-10(a)-(b), 80a-15(a)-(c), so fund trustees can act as "'independent watchdogs.'" *Burks*, 441 U.S. at 484 (quoting *Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir. 1977)). At least 40 percent of the mutual fund's trustees must be disinterested with respect to the investment adviser. 15 U.S.C. §80a-10(a). And those disinterested trustees have special roles. Critically, they must "review and approve the contracts of the investment advisor." *Burks*, 441 U.S. at 483. And while all fund trustees vote on the agreement between the fund and its investment adviser, the *fees* paid to the investment ad-

viser can be established *only* by a majority of *disinterested* trustees. 15 U.S.C. §80a-15(c).

The ICA and SEC also require investment advisers to make, and mutual fund trustees to review, extensive disclosures relating to the adviser's fees, costs, and profits. Section 15(c) of the ICA requires investment advisers to furnish, and fund directors to examine, all information reasonably required to evaluate the terms of any advisory contract. 15 U.S.C. §80a-15(c). SEC rules require, among other things, disclosure of (a) the costs of the services the investment adviser provides to the fund, (b) the profits the investment adviser and its affiliates realize from their relationship with the fund, (c) the extent to which economies of scale are realized as the fund grows, and (d) how such economies of scale benefit investors. See 69 Fed. Reg. 39798, 39801 (June 30, 2004).

This case arises under §36(b) of the ICA, 15 U.S.C. §80a-35(b), which was added in 1970 together with other provisions reinforcing the independence of fund trustees. See Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413. Section 36(b) provides that investment advisers have "a fiduciary duty with respect to the receipt of compensation" from the mutual funds they advise. 15 U.S.C. §80a-35(b). Section 36(b) also creates a private cause of action that shareholders may assert on behalf of a fund against the fund's investment adviser "for breach of fiduciary duty in respect of such compensation or payments paid" to the investment adviser. *Ibid.* The plaintiff in such an action has "the burden of proving a breach of fiduciary duty." 15 U.S.C. §80a-35(b)(1).

B. The Growth of the Mutual Fund Industry

Since the enactment of §36(b) in 1970, the mutual fund industry has experienced explosive growth and dramatically increased competition. Today, nearly 700 financial

services companies compete aggressively, offering fund "families" with an array of individual funds across multiple asset classes and investment objectives. ICI Fact Book 16 (May 2008), http://www.ici.org/stats/latest/2008_factbook.pdf. Those companies offer investors a choice of over 8,700 open-end mutual funds, over 660 closed-end funds, and over 600 Exchange Traded Funds. *Id.* at 15. Multiple organizations publicly review and rate those funds' fees, costs, and performance.

Funds typically do not switch advisers; advisers thus rarely compete for the business of particular funds. But advisers and the funds they form compete intensely for investors' dollars on the basis of factors such as fees, performance, and service. Thus, "price competition is in fact a strong force constraining fund advisors." Coates & Hubbard, *supra*, at 153, 164, 196.[1]

II. PROCEEDINGS BELOW

Respondent Harris Associates L.P. ("Harris") is a highly regarded investment adviser. During the relevant period, the funds Harris managed outperformed the market benchmark and virtually every fund in their peer groups. Petitioners are various individuals who own shares in funds for which Harris served as investment adviser.

A. Harris's Services and Fees

Petitioners brought this action on behalf of three funds in the Oakmark "family" of mutual funds for which

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[1] The assertion that "an investment adviser has the ability to create its own clients by forming the very mutual funds to which it provides its services," Brief of *Amici Curiae* Law Professors 3, is thus misleadingly incomplete. An adviser may create an investment company that serves as a vehicle for pooling assets. But, in so doing, it does not create "clients," as it still must convince investors to put their money into that fund. Those potential clients have the option of investing in more than 9,000 other funds.

Harris serves as investment adviser: the Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund (the "Funds"). C.A. App. 66. The complaint alleged that Harris breached its fiduciary duty to the Funds with respect to the receipt of compensation under §36(b) by charging "excessive" fees. *Id.* at 46-47.

1. *Harris's Performance Record*

The complaint sought damages for the one-year period ending August 16, 2004. Pet. App. 29a.[2] Reports prepared for the Funds' trustees by a third-party industry consultant—Lipper, Inc.—showed that Harris's performance during that period was extraordinary. The Lipper materials compared each of the three Funds' investment performance and fees to a peer group as well as to a benchmark for each Fund's respective asset class. C.A. App. 71-72.

The Oakmark Global Fund. For the three-year period ending March 31, 2004, the Global Fund generated an average annual return of 22.36% net of fees, the single best performance of *any* of the 254 funds that Lipper considered comparable. That return was nearly 10 times the benchmark Lipper Global Fund Index, which had an average annual return of 2.31% during the same period. C.A. App. 74. The Global Fund's average annual net return over the preceding four-year period was 20.24%, again the single best performance of any comparable fund for that period—and far above the benchmark, which had an average annual *loss* of 4.8%. See *ibid.*[3]

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[2] Damages are limited to the "period prior to one year before the action was instituted." 15 U.S.C. §80a-35(b)(3); see *Daily Income Fund*, 464 U.S. at 526 n.2 ("[R]ecovery is limited to actual damages for a period of one year prior to suit * * * .").

[3] Shares of the Oakmark Global Fund were first offered for sale on August 4, 1999, so a five-year performance figure was not used in the 2004 Lipper report.

The Oakmark Equity and Income Fund. For the three-year period ending March 31, 2004, the Equity and Income Fund generated an average annual return of 12.49% net of fees, the third best performance of 445 peer funds during that period; the Fund's return was over three times the benchmark Lipper Balanced Fund Index, which had an average annual return of 3.76%. C.A. App. 73. For the five-year period ending March 31, 2004, the Equity and Income Fund had an average annual net return of 13.91%, the single best performance in its peer group, and far above the benchmark of 3.11%. *Ibid.*

The Oakmark Fund. For the three-year period ending March 31, 2004, the Oakmark Fund generated an average annual return of 6.22% net of fees. Lipper ranked it 12th out of the 307 funds Lipper considered comparable. It also comfortably outperformed the benchmark Lipper Large-Cap Value Index, which had an average annual return of 1.43%. C.A. App. 73. For the five-year period ending March 31, 2004, the Oakmark Fund's average annual net return was 5.29%, well above the benchmark's 1.22%, giving it a rank of 18 out of 224 comparable funds. See *ibid.*

2. *Harris's Fees*

Notwithstanding Harris's extraordinary performance during the relevant period, Harris's fees were unremarkable. For its services as investment adviser, each Fund paid Harris an advisory fee calculated as a percentage of the Fund's net assets at the end of each month. C.A. App. 67. As required by statute, that fee schedule was set forth in the written advisory agreement that governs the management of each Fund. The agreements, in turn, were negotiated and approved each year by the Funds' trustees, C.A. App. 67, and fully disclosed to shareholders in each Fund's Prospectus and Statement of Additional Information, *id.* at 68-69.

The fee schedule for each of the Funds also featured "breakpoints," *i.e.*, asset levels at which the percentage fee declines. C.A. App. 67. During the relevant period, the annual contract renewal process resulted in the initiation of additional breakpoints in the Funds' fee schedules—further decreasing the fee rate as the Funds grow in size. *Id.* at 68. The following table summarizes the fee schedule for each Fund:

The Oakmark Fund	Equity & Income Fund	Global Fund
First $2.0 billion under mgmt: 1.00%	First $5.0 billion under mgmt: 0.75%	First $2.0 billion under mgmt: 1.00%
Next $1.0 billion under mgmt: 0.90%	Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2003)*	
Next $2.0 billion under mgmt: 0.80%	Next $2.5 billion under mgmt: 0.675% *(New breakpoint as of 11/1/03)*	
Next $2.5 billion under mgmt: 0.75%	Next $2.5 billion under mgmt: 0.65% *(New breakpoint as of 11/1/2003)*	Next $2.0 billion under mgmt: 0.95% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2004)*		
Net assets in excess of $10 billion: 0.65% *(New breakpoint as of 11/1/2004)*	Net assets in excess of $12.5 billion: 0.60% *(New breakpoint as of 11/1/2004)*	Net assets in excess of $4 billion: 0.90% *(New breakpoint as of 11/1/2003)*

Ibid.

The Lipper materials included comparative data on fees. Each Fund paid fees approximating the median charged by Harris's peers for similar funds. The 2004 Lipper report shows that the Global Fund's total expenses were 0.168% below the median for its peer group, the Equity and Income Fund's were 0.025% above the median for its peer group, and the Oakmark Fund's were 0.174% above the median for its peer group. C.A. App.

71-72. The Funds thus produced extraordinary, above-market returns for at-market fees.

3. *The Annual Negotiation Process*

The ICA requires periodic renegotiation of investment advisory contracts and shareholder approval of material changes. 15 U.S.C. §80a-15(a). The Funds' trustees and Harris negotiated Harris's fees over a period of several months and through multiple meetings. C.A. App. 69-70. Throughout that process, the Funds' trustees were advised by independent, outside legal counsel. *Id.* at 70. As required by §15(c) of the ICA, Harris provided the Funds' trustees with information on a variety of topics at their request—information that far exceeded what a negotiator ordinarily provides its counterparty in arm's-length bargaining. That included the investment performance of the Funds; the profitability of the contracts to Harris (including detailed information about Harris's expenses); details of transactions between the Funds and entities affiliated with Harris; benefits accruing to Harris in addition to fees (*e.g.*, use of "soft dollars" to offset the cost of research services); and information regarding best execution of transactions for each Fund and compliance with investment restrictions. C.A. App. 70-71.

Harris also serves as investment adviser to a variety of non-mutual fund clients, including pension funds, institutional investors, and high net-worth individuals. In addition, Harris contracts to provide sub-advisory services to various mutual funds for which other investment advisers act as the primary adviser. C.A. App. 72. Harris provides a spectrum of services to those other accounts that often differ substantially from the services provided to the Funds; the fees are likewise often different. *Id.* at 73. At the request of the trustees, Harris provided the Funds' trustees with data comparing the fees Harris charged other clients to the fees it charged the Funds, as well as descriptions of how the services

Harris provided other clients differed from the services it provided to the Funds. *Ibid.*

B. The District Court's Decision

Petitioners alleged that, despite Harris's superior performance and its full disclosure of all fees, profits, and prices charged to other clients, Harris breached its fiduciary duty with respect to the receipt of compensation under §36(b) of the ICA. The complaint specifically invoked the formula articulated in *Gartenberg* v. *Merrill Lynch*, 694 F.2d 923, 928 (2d Cir. 1982) ("*Gartenberg*"), alleging that Harris's fees were "so disproportionately large that [they] bear[] no reasonable relationship to the services rendered." C.A. App. 33 (quoting *Gartenberg*, 694 F.2d at 928).

Following years of discovery, the parties filed cross-motions for summary judgment. The district court granted Harris's motion and denied petitioners'. Pet. App. 15a-33a. Applying *Gartenberg*, the district court held that petitioners had not raised a triable issue on "whether the fees charged to the Funds" during the relevant period were "so disproportionately large that they could not have been the result of arm's-length bargaining." *Id.* at 29a; see also *id.* at 28a. After careful examination of "all facts pertinent to the amount of fees paid"—including the amount of fees and the negotiations that set them—the district court had little difficulty concluding that petitioners' claims lacked merit. *Id.* at 27a. There was no "dispute that Harris's fees were comparable to those charged by other similar funds." *Id.* at 30a. Petitioners did not deny that the Funds "performed well"—extraordinarily well—"during the damages period." *Id.* at 30a, 32a. And there was no genuine dispute that the Funds' trustees "operat[ed] without any conflict" that would prevent "arm's-length negotiations" with Harris. *Id.* at 31a. The undisputed facts showed that the "shareholders' interests were represented at the negoti-

ating table by a group of people who were capable of giving those interests primacy." *Ibid.* The district court further concluded that the "breakpoints" were not unreasonable; they were "comparable to what shareholders in other mutual funds had accepted." *Id.* at 31a-32a.

The district court also rejected petitioners' argument that Harris's fees were unreasonable because Harris charged some institutional clients lower rates than it charged the Funds. Pet. App. 30a. The undisputed facts established that Harris provided "more limited" services to those clients than it provided to the Funds. *Id.* at 16a.[4] The court further held that, even if one assumed that the institutional investors received identical services, the evidence did not show that the fees paid by the Funds exceeded the amount that could have resulted from arm's-length negotiations. The Funds' fees fell comfortably within the range of all fees Harris received from all types of clients. *Id.* at 30a. That, the court explained, "prevent[s] a conclusion that the amount of fees indicates that self-dealing was afoot." *Ibid.* The court concluded that evidence of bargaining by unconflicted and fully informed trustees acting in the shareholders' interest, Harris's unparalleled performance, and the fact that the fees fell within the range of market rates—when coupled with petitioners' failure to generate contrary proof—prevented the conclusion that the fee was "so disproportionately large" as to trigger liability under §36(b). Pet. App. 29a.

C. The Court of Appeals' Decision

The Seventh Circuit affirmed. Pet. App. 1a-14a. On appeal, petitioners urged that the Seventh Circuit "should *not* follow *Gartenberg*" and should instead exa-

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[4] Any suggestion that the services were "indistinguishable," Pet. 9, is thus incorrect. The services provided to the institutional investors were "more limited than those * * * provided to the Funds." Pet. App. 16a.

mine the "reasonableness" of the adviser's fee. *Id.* at 6a (emphasis added). *Gartenberg*, petitioners complained, "relies too much on market prices as the benchmark." *Ibid.*

The court of appeals was not persuaded. The court explained that §36(b) by its terms imposes a "fiduciary duty" with respect to fees; it does not say that "fees must be 'reasonable' in relation to a judicially created standard." Pet. App. 8a. "A fiduciary duty differs from rate regulation." *Ibid.* Under traditional principles, a fiduciary "owes an obligation of candor in negotiation, and honesty in performance," but may negotiate in its own interest with respect to compensation. *Id.* at 8a-9a (citing *Restatement (Second) Trusts* §242 & cmt. f). The court also acknowledged limits: "It is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." *Id.* at 9a.

The court of appeals also rejected the premise that the relationship between an investment adviser and the fund necessarily produces excessive fees. Pet. App. 7a. Funds and their advisers must compete for investor dollars. "Holding down costs is vital in competition, when investors are seeking maximum return net of expenses." *Ibid.* Since "management fees are a substantial component of administrative costs, mutual funds have a powerful reason to keep them low unless higher fees are associated with a higher return on investment." *Ibid.* "That mutual funds are 'captives' of investment advisers does not curtail this competition. An adviser can't make money from its captive fund if high fees drive investors away." *Ibid.* Today, the court of appeals continued, "thousands of mutual funds compete." *Id.* at 11a. Consequently, even if funds do not fire their advisers, investors "can and do 'fire' advisers cheaply and easily by moving their money" to other funds. *Id.* at 11a-12a.

Finally, the court of appeals rejected petitioners' claim that a breach of duty arose because Harris charges other clients lower rates. Pet. App. 13a. "Different clients call for different commitments of time," different services, and varying degrees of complexity in conducting "research, valuation and portfolio design." *Ibid.* For example, the court explained, "[p]ension funds have low (and predictable) turnover of assets." *Ibid.* But "[m]utual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions." *Ibid.* Different elasticities of demand also mean that joint costs are not necessarily allocated *pro rata*. *Ibid.*

In the course of its discussion, the court of appeals expressed "skeptic[ism]" that *Gartenberg* had relied sufficiently on "markets," and accordingly "disapprove[d]" of aspects of *Gartenberg*'s "approach." Pet. App. 7a, 8a. The panel expressed concern that *Gartenberg* was not sufficiently tethered to §36(b)'s text. Liability for breach of an adviser's statutory "fiduciary duty with respect to the receipt of compensation," the court observed, should be tested against familiar principles of fiduciary obligation—and not by judicial review through a subjective lens of reasonableness tantamount to rate regulation. Nonetheless, the court of appeals agreed with *Gartenberg* that the amount of fees could by itself support a finding of fiduciary breach. A fee could be so "unusual" that it compelled the "infer[ence] that deceit must have occurred" or that there was an "abdicat[ion]" of responsibility. Pet. App. 9a. Here, however, petitioners had not identified facts to support such an inference. *Id.* at 13a-14a.

The court of appeals denied rehearing *en banc* by an equally divided vote. The dissenting judges acknowledged that "[t]he *outcome* of this case may be correct." Pet. App. 42a. And they agreed that the panel's test—whether the compensation is "so unusual" as to raise an

inference of breach—"might not seem to differ materially from" *Gartenberg*, which asks whether compensation is "so disproportionate" as to bear no reasonable relationship to the services rendered. *Id.* at 41a. But the dissenting judges expressed concern that the panel opinion could be read to preclude courts from comparing the adviser's fee to anything but the fees charged to other mutual funds. *Ibid.*

REASONS FOR DENYING THE PETITION

Petitioners claim that the decision below creates a circuit conflict on the standard for determining whether the size of the fee charged by an investment adviser establishes that it breached its "fiduciary duty with respect to the receipt of compensation" under §36(b) of the ICA, 15 U.S.C. §80a-35(b). But the difference they posit is one of articulation, not substance.

In *Gartenberg* v. *Merrill Lynch*, 694 F.2d 923 (2d Cir. 1982), the Second Circuit established a demanding standard. Compensation will not violate §36(b), that court held, unless the fee is so "disproportionately large that it bears no reasonable relationship to the services rendered." *Id.* at 928. The decision below echoes that standard, acknowledging that fees that are "so unusual" as to create an inference of fiduciary breach trigger §36(b) liability. Pet. App. 9a. There is no reason to believe that the two formulations will lead to different results; any fee that is "so disproportionately large" as to have "no reasonable relationship" to the services rendered would almost certainly be "so unusual" as to raise an inference that fiduciary duties were violated and vice versa. Contrary to petitioners' claims, the decision below does *not* hold that approval by a fund's board of directors is conclusive. And while petitioners complain that the decision below refused to compare the fees Harris received from the Funds to the fees Harris received from certain insti-

tutional investors, they ignore the undisputed facts and *Gartenberg*'s own rejection of the identical comparison.

Tellingly, petitioners identify no case in any other court that would have been decided differently under the two articulations of the relevant standard. To our knowledge, no plaintiff has ever prevailed on a §36(b) claim, even under the *Gartenberg* articulation petitioners now propose (after opposing it in both courts below). Only two courts of appeals have thoroughly addressed this issue, which appears unlikely to arise with frequency in the future. And petitioners here cannot prevail under *any* standard adopted by any court of appeals. The district court rejected their claims under the *Gartenberg* formula they cited in their complaint, later abandoned, but now seek to resurrect.

Nor does the Seventh Circuit's view of competition in the mutual fund industry today provide any basis for review. Some 25 years of experience and industry growth informed the Seventh Circuit's perspective. This Court does not adjudicate competing law-and-economics analyses that lack real-world impact on the resolution of actual cases. Absent actual disparate outcomes, review is unwarranted.

I. THE ALLEGED CIRCUIT CONFLICT IS ILLUSORY

The decision below does not conflict with *Gartenberg* and cases that purportedly follow *Gartenberg*. To the contrary, the conflict petitioners posit is wholly academic. It does not alter the result in this case or any other.

A. The Legal Formula Adopted Below Is Substantively Identical to *Gartenberg*

1. In *Gartenberg*, the Second Circuit addressed the considerations that can support the conclusion that a mutual fund adviser violated its "fiduciary duty with respect to the receipt of compensation" under §36(b). Like the decision below, *Gartenberg* acknowledged that

conduct amounting to a traditional fiduciary breach—such as deceit, withholding relevant information, or failure to bargain in good faith—could establish a breach of the statutory obligation. And it went on to address the plaintiffs' claim that the fees paid to the adviser in that case were, by themselves, so excessive that they amounted to a breach of fiduciary duty. But *Gartenberg* recognized that §36(b) was not a license for courts to impose their own judgments about the fairness or reasonableness of fees, and it rejected the plaintiffs' claim that §36(b) requires fees to be substantively fair or reasonable. 694 F.2d at 928. Instead, the Second Circuit held that, to violate §36(b), "the adviser-manager must charge a fee that is *so disproportionately large* that it bears *no reasonable relationship* to the services rendered and could not have been the product of arms'-length bargaining." *Ibid.* (emphases added).

That determination must be made "in the light of all of the surrounding circumstances." *Gartenberg*, 694 F.2d at 928. Those circumstances included "rates charged by other adviser-managers to other similar funds," *id.* at 929, the adviser's "cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager." *Id.* at 930. The court also focused on investors' relative returns compared to competitor funds. *Ibid.* Finally, the Second Circuit pointed to good-faith bargaining by a fund's independent trustees as an important ingredient in the fiduciary calculus. *Id.* at 930, 931.

The decision below establishes a similar formula and looks to similar considerations. Like the Second Circuit in *Gartenberg*, the decision below refused petitioners' invitation to adopt a subjective "reasonableness" standard for adviser fees. Pet. App. 8a ("Section 36(b) does not say

that fees must be 'reasonable.'"). Instead, the Seventh Circuit held that §36(b) by its terms established a breach-of-fiduciary-duty standard. That standard gives rise to liability when a fee results from conduct familiarly understood as a fiduciary breach—such as where there is incomplete disclosure, "deceit," trickery, or a failure to meet the requirements of "candor in negotiation" and "honesty in performance." Pet. App. 8a. If an adviser thwarts fair negotiation, that can violate §36(b). See *id.* at 14a.

But the decision below also recognized that §36(b) could be violated based on the size of the fee alone—such as where compensation is "so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." Pet. App. 9a. That ruling closely echoes *Gartenberg*. In the Second Circuit, liability is triggered by a fee that is "so disproportionate" that it has "no reasonable relationship" to the services rendered and thus "could not have been the product" of arm's-length negotiations. *Gartenberg*, 694 F.2d at 928. Under the decision below, a breach similarly may be shown if compensation is "*so unusual*" that deceit or an "abdicat[ion]" of arm's-length bargaining "*may be inferred*." Pet. App. 8a, 13a-14a. Thus, both circuits will consider a fee's size, by itself, in determining whether the fiduciary relationship has broken down. And they use similar standards—compensation that is "so disproportionate" as to have no reasonable relationship to services (*Gartenberg*) or "so unusual" as to evidence deceit or abdication (this case) can violate §36(b).

The slight differences in articulation between those two formulations cannot conceivably produce different legal outcomes on similar facts. One district court has already observed that *Gartenberg* and the decision below "lead to the same place." *In re Mutual Funds Inv. Litig.*, MDL No. 04-MD-15863, — F. Supp. 2d —, 2008

WL 5412407, at *15 (D. Md. Dec. 30, 2008). And the district court here easily rejected petitioners' claims under *Gartenberg*'s approach. See pp. 22-24, *infra*. Under any articulation of the §36(b) standard, Harris's fees are neither "so unusual" as to raise an inference of fiduciary breach nor "so disproportionately large" as to have no relationship to the services rendered—particularly considering the Funds' extraordinary, first-in-class performance.

2. Ignoring the virtual identity of the two formulations, petitioners repeatedly claim that the decision below requires proof that the adviser "misled the fund's directors" in obtaining approval of the compensation. Pet. 2, 13; *id.* at i (Question Presented). Without this proof, petitioners allege, the Seventh Circuit will uphold compensation, "no matter how excessive." *Id.* at 13, 19. The decision below, they further urge, makes approval of an adviser's fees "conclusive," contravening the ICA's direction that board approval "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.* at 2, 19, 21-22 (citing 15 U.S.C. §80a-35(b)(3)).

That misreads the decision below. The decision does hold that directly proving "deceit," or lack of "candor in negotiation" and "honesty in performance," *can* establish breach of fiduciary duty with respect to compensation. But petitioners ignore the opinion's express statement that a highly "unusual" fee *itself* can cause a court to "*infer* that deceit" or abdication of responsibility "*must have* occurred." Pet. App. 9a (emphases added).[5] In

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[5] Petitioners draw their claim that board approval is "conclusive" from the Seventh Circuit's description of the *general* law of trusts. See Pet. App 9a (citing John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L.J. 625 (1995)). But the court nowhere held that board approval is "conclusive" with respect to

other words, an excessive fee can be enough to prove liability. That ruling mirrors *Gartenberg*, which likewise considers whether trustees "are fully informed" by advisers and whether trustees exercise "care and conscientiousness," but also asks whether a fee is "so disproportionately large" as to raise flags about "a breach of fiduciary duty." 694 F.2d at 930.

The Seventh Circuit's claim to "disapprove the *Gartenberg* approach" thus is best understood as an objection to aspects of *Gartenberg*'s reasoning, not its standard. Pet. App. 8a. The decision below reads *Gartenberg* as invoking §36(b)'s legislative history rather than its text and as having articulated its formula as a substantive limit on the amount of fees—*i.e.*, as a form of "judicial rate setting" that, in both courts' view, was not the statute's object. Pet. App. 8a, 14a. The decision in this case, by contrast, invokes §36(b)'s text, which imposes a "fiduciary duty," to require courts to draw on familiar fiduciary principles in adjudicating §36(b) claims. But the decision below agreed with *Gartenberg* in substance that the amount of fees by itself can establish liability, because truly unusual compensation can *evidence* a fiduciary breach. *Id.* at 9a. Even the Seventh Circuit judges favoring *en banc* review agreed with the panel's approach. They did not construe §36(b) as a rate-regulation statute that substantively limits compensation. "[T]he point," they urged, "is that unreasonable compensation can be *evidence* of a breach of fiduciary duty." *Id.*

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§36(b) claims. The court expressly required, for example, that the adviser "make full disclosure and play no tricks." Pet. App. 8a. More importantly, immediately after that discussion, the court of appeals recognized that a fee could be "so unusual that a court will infer that deceit must have occurred or that the persons responsible for decision have abdicated." *Id.* at 9a.

at 41a-42a (emphasis added).[6] To the extent the decision below departs from *Gartenberg*'s reasoning, it does so to anchor *Gartenberg*'s result in statutory text and familiar principles of fiduciary responsibility. And, while the decision in this case also criticizes *Gartenberg* for insufficient focus on "markets," *id.* at 8a, 11a-13a, that merely represented the panel's effort to modernize *Gartenberg*'s reasoning to account for the spectacular growth in competition over the past 30 years—not disagreement with *Gartenberg*'s substantive standard. See pp. 25-26, *infra*.

3. Ultimately, petitioners rest their argument on the claim that Harris charged certain institutional clients lower rates than it charged the Funds. The court of appeals, they claim, erred in failing to consider that difference. Pet. 2-3, 19-20. There is no dispute that Harris fully disclosed the different fees it charged its other clients. It provided disclosures (such as its profit margins) that far exceeded the information that is typically exchanged in arm's-length negotiation. Pet. App. 16a; C.A. App. 73. Nor can there be a serious claim that the different charges themselves violate Harris's fiduciary duty or support a conflict with *Gartenberg*.

As the opinion below explained, different clients impose different costs. They call for "different commitments of time," Pet. App. 13a, and impose other constraints. For example, while "[p]ension funds have low (and predictable) turnover of assets[,]" mutual funds "must hold some assets in high-liquidity instruments to facilitate redemptions," which "complicates an adviser's task." *Ibid.* The district court reached that conclusion on

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[6] For the same reason, the court of appeals' decision does not conflict with *Meyer* v. *Oppenheimer Management Corp.*, 764 F.2d 76 (2d Cir. 1985). See Pet. 16. *Meyer* rejected the view that board approval by itself is conclusive—a view likewise rejected by the decision in this case. See pp. 17-18 & n.5, *supra*.

the undisputed facts here: "The services Harris provided to institutional clients * * * were more limited than those they provided to the Funds." Pet. App. 16a. As petitioners state, "the evidence here showed" that "Harris charged the Oakmark funds more than institutional clients, but also that it cost Harris significantly less to serve the institutional clients." Pet. 27.

In any event, *Gartenberg* rejected the identical argument—"that the lower fees charged by investment advisers to large pension funds should be used as a criterion for determining fair advisory fees for money market funds." 694 F.2d at 930 n.3. The court observed that "[t]he nature and extent of the services required by each type of fund differ sharply": "the pension fund does not face the myriad of daily purchases and redemptions throughout the nation which must be handled by the [money market] Fund." *Ibid.* The fact that the decision below and *Gartenberg* rejected the same comparison for the same reasons demonstrates consistency, not conflict.

For like reasons, petitioners err in claiming that the court of appeals' "so unusual" standard is different from *Gartenberg*'s "so disproportionate" standard because the former compares only the fees charged to different mutual funds. See Pet. 19-20. The court of appeals did not hold that institutional-client fees are irrelevant where the services provided are similar. To the contrary, the decision suggested that comparison with "similar" or "comparable" funds would be highly relevant. Pet. App. 9a. What was lacking here was the factual predicate of similarity. *Id.* at 13a, 16a. Other authorities have likewise refused to compare fees charged to mutual funds with rates charged to institutional clients where the services provided to each were distinct. See, *e.g.*, *Strougo* v. *BEA Assocs.*, 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002); Coates & Hubbard, *supra*, at 185 ("Significant product and cost differences separate the advising of retail mutu-

al funds and the advising of public pension plans," making "simple price comparisons * * * invalid").

Petitioners thus err when they claim that institutional-client fees constitute "powerful—and undisputed—evidence that the fee charged in this case would not have been agreed to in an arm's-length negotiation." Pet. 2-3. The court of appeals below, the district court below, *Gartenberg*, and other cases have all concluded in factually similar circumstances that such a comparison is inapt because institutional-client services are different from mutual-fund services. Petitioners may disagree with that conclusion *factually*, but they did not adduce competent evidence to support that contention. And any such factbound dispute does not warrant review.[7]

B. There Is No Conflict with the Decisions of Other Circuits

Petitioners claim that the Third and Fourth Circuits "follow the *Gartenberg* standard" and that the Seventh Circuit's decision therefore conflicts with decisions of those courts. Pet. 14-19. That claim, however, is entirely derivative of the alleged (but nonexistent) conflict with *Gartenberg*. It is also independently unpersuasive.

Petitioners, for example, claim a conflict with *Migdal* v. *Rowe Price-Fleming International, Inc.*, 248 F.3d 321 (4th Cir. 2001). But that decision did not adopt *Gartenberg* wholesale. As petitioners concede, "[r]ather than following the multi-factor [*Gartenberg*] approach," the Fourth Circuit there "focused narrowly on one particular

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[7] The point is also irrelevant on this record. After concluding that the services rendered to pension funds and mutual funds were different, the district court nonetheless "assum[ed] for the mere sake of comparison" that the services provided were "indistinguishable." Pet. App. 30a. Yet, applying *Gartenberg*, the district court nonetheless granted summary judgment because Harris's fees were within the range that would result from arm's-length bargaining. *Ibid.*

factor." Pet. 18. The Fourth Circuit reasoned that, "in order to determine whether a fee is excessive for purposes of Section 36(b), a court must examine the relationship between the fees charged and the services rendered by the investment adviser." *Migdal*, 248 F.3d at 327. The court then dismissed the case because plaintiffs failed to plead *anything* about that relationship, despite repeated opportunities. *Id.* at 327-328. That hardly establishes a conflict with the decision below.

Petitioners also invoke *Krantz* v. *Prudential Investments Fund Management LLC*, 305 F.3d 140 (3d Cir. 2002). See Pet. 18. But *Krantz* does not even cite *Gartenberg*. Instead, the court summarily "adopt[ed] the Fourth Circuit rationale" in *Migdal* that "dismissal for failure to state a claim with respect to excessive compensation was appropriate since Plaintiff failed to allege any facts indicating that the fees received were disproportionate to services rendered." *Krantz*, 305 F.3d at 143. That hardly establishes a conflict either.

C. This Case Is Not an Appropriate Vehicle

1. Even if *Gartenberg* and the decision below *could* yield different results on the same facts, they certainly would not do so on these facts. Applying *Gartenberg*, the district court concluded that petitioners lacked the necessary proof to prevail. Pet. App. 27a-33a. The undisputed facts established that Harris's fee was not so "disproportionately large that it bears no reasonable relationship to the services rendered." *Gartenberg*, 694 F.2d at 928. In urging otherwise, petitioners relied almost exclusively on the fees Harris charged institutional clients. Pet. App. 30a. But *Gartenberg* expressly refused to consider fees charged to institutional clients as evidence of disproportionate fees, 694 F.2d at 930 n.3, other courts have as well, see p. 20, *supra*, and the district court found the comparison factually inapt here, Pet. App. 16a; pp. 19-20, *supra*. In any event, taking into account fees charged to

institutional clients, the district court held that Harris's fees fell within "a range of prices that investors were willing to pay," "thus preventing a conclusion * * * that self-dealing was afoot." Pet. App. 30a.

All the other factors considered in *Gartenberg* weigh heavily against petitioners. As in *Gartenberg*, "the services rendered by [Harris]" were "of the highest quality"—a factor that figured prominently in the *Gartenberg* decision. 694 F.2d at 930. Indeed, while investors in *Gartenberg* received slightly "better-than-average return[s]," *id.* at 926, 930, investors in Harris funds enjoyed first-in-class performance—returns during the relevant period were often two, three, or almost ten times the benchmark norm, see pp. 5-6, *supra*.[8] Moreover, petitioners "do not dispute that Harris's fees were comparable to those charged by other similar funds," another factor considered by *Gartenberg*. Pet. App. 30a; *Gartenberg*, 694 F.2d at 927, 929; see also Pet. App. 31a ("Plaintiffs do not provide any evidence of what savings were gained from economies of scale.").

Finally, the disclosures to the trustees here were extensive, indeed, extraordinary. Harris disclosed not only the services it rendered, but also the amount of its *profits* from advising the funds, as well as the amounts it charged all its *other* clients. See pp. 8-9, *supra*. No arm's-length negotiator would have access to such information. As in *Gartenberg*, that evidence demonstrated "the trustees were aware of or could obtain the essential

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[8] Rather than dispute the "returns the Funds produced up until March 2004," petitioners urged the district court to consider performance after the damages period. Pet. App. 32a. The district court properly declined to do so because "how the Funds performed after the damages period is not relevant to the quality of services rendered before that time." *Ibid.* Nowhere does the petition take issue with that factbound determination.

facts needed to negotiate a reasonable fee" and that the "non-affiliated Fund trustees * * * had considered extensive relevant information" before approving the fee. 694 F.2d at 933; see Pet. App. 16a (detailing information provided to trustees); *id.* at 31a (finding that "the shareholders' interests were represented at the negotiating table by a group of people who were capable of giving those interests primacy"). Indeed, the trustees' good-faith negotiations resulted in the inclusion of additional breakpoints, which *Gartenberg* recognized as a strong indicator of arm's-length negotiation. 694 F.2d at 931; Pet. App. 29a-30a, 31a-32a. The district court thus correctly concluded that, under *Gartenberg*, petitioners had failed to show "a fundamental disconnect between what the Funds paid and what the services were worth," and so could not show a breach of fiduciary duty. Pet. App. 32a. Even the judges favoring rehearing *en banc* agreed that "the *outcome* of this case may be correct." *Id.* at 42a. This Court should not grant review in a case where the outcome is the same regardless of which purportedly conflicting test is applied, much less where things may yet be unresolved even in the circuit below.

2. Perhaps recognizing that they could not prevail even under *Gartenberg*, in both courts below petitioners urged *rejection* of *Gartenberg*, characterizing it as too demanding. Pet. App. 6a, 28a. It is obviously incongruous for petitioners to champion now the very case they criticized below. More important, petitioners would be in no position to defend or promote *Gartenberg* in this Court if their petition were granted. After all, they *lost* under that formula in the district court. Unable to prevail under any formula pronounced by any court of appeals, petitioners would require the adoption of a new, more lenient standard that no court of appeals has ever adopted. This Court should not grant review based on a

purported conflict where the petitioner cannot prevail under any formula adopted to date.

3. Finally, petitioners devote a substantial portion of their petition to the claim that one of Harris's disinterested directors was in fact interested, and that Harris committed various other fiduciary breaches. Pet. 26-29. The district court specifically rejected those claims, Pet. App. 24a-26a, 30a-32a, and the court of appeals affirmed, *id.* at 2a-3a.[9] Those factbound allegations also make this case an unsuitable vehicle to address the §36(b) question the petition purports to present.

D. The Petition Raises Largely Academic Issues That Lack Recurring Significance

The petition does not so much raise a genuine dispute concerning the proper standard that must be applied in recurring disputes as it raises an academic dispute about economics.

1. In the courts below, petitioners urged that *Gartenberg* should not be followed because it relies too much on market comparisons. The decision below, by contrast, expressed "skepticism" about *Gartenberg* because *Gartenberg* "relied too little on markets." Pet. App. 7a-8a. While *Gartenberg* commented on the absence of competition among investment advisers for fund advisory contracts, *Gartenberg* did not mention that investment advisers compete with each other for investors' dollars through the funds they form. "[A] lot has happened" in the many years since *Gartenberg* was decided in 1982. *Id.* at 11a. Now that the fund industry has matured into

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[9] The court of appeals dismissed petitioners' interested-director argument because that director's vote was immaterial to the Board's approval of advisory fees, and because violations of the ICA's independent-director requirements cannot be pursued under §36(b)'s private right of action. No court has reached a contrary result. See *Migdal*, 248 F.3d at 328-329.

a vibrant and competitive marketplace, the Seventh Circuit observed, there is every incentive for funds to keep fees down: Funds compete based on performance net of costs (including fees). *Id.* at 7a. The explosion in the number of mutual funds, and the resulting intense price competition between funds, ensures that competition keeps advisory fees low—since investors can vote with their feet and invest in lower-cost funds. *Id.* at 11a-13a.

The Second Circuit and Judge Posner, of course, may have a different view about mutual fund markets. Judge Posner flagged the panel's "economic analysis" as "ripe for reexamination," Pet. App. 37a, and offered four pages of his own economic musings, *id.* at 37a-41a. But it is hard to see how that discussion is anything but academic. The statutory question is what it means to violate a fiduciary duty in connection with compensation—not where supply and demand curves intersect. On the legal question, the courts' "two approaches lead to the same place." *In re Mutual Funds Inv. Litig.*, 2008 WL 5412407, at *15. Because any economics debate is beside the point, there is no reason for review at this point. This Court reviews judgments, not statements in opinions—and it certainly does not grant review to address abstract debates not grounded in legal principles.

2. The Second and Seventh Circuits, moreover, are the only ones to have addressed §36(b) in any analytical detail in the nearly 40 years since that provision was enacted. Petitioners have identified no case that would be resolved differently under either articulation. It is therefore hard to see how the issue can be deemed important, much less sufficiently important to warrant this Court's review.

To the contrary, on the infrequent occasions these questions are litigated, the outcomes are uniform. As Judge Posner noted, even under *Gartenberg*, "litigation in excessive fee cases has resulted almost uniformly in

judgments for the defendants." Pet. App. 36a (quoting James D. Cox *et al.*, *Securities Regulation: Cases and Materials* 1211 (3d ed. 2001)). Indeed, since *Gartenberg*, there have been only four trials *ever* on claims that advisory fees violated §36(b)—and all of them were in the Second Circuit.[10] No claim under §36(b) in any other circuit appears to have progressed to summary judgment until this case. Moreover, since the adoption of §36(b) in 1970, the Securities and Exchange Commission has not brought a single action for breach of an adviser's fiduciary duty with respect to compensation. Rather, the SEC has expressed the view that "[t]he Investment Company [Act's] requirements concerning the organizational structure of open-end investment companies, which interpose independent directors as a check on investment company sponsors, are fundamentally sound [and] provide significant protections against the inherent conflict between the interests of public investors and the interests of fund sponsors." SEC Div. of Inv. Mgmt., *Protecting Investors: A Half Century of Investment Company Regulation*, at xxix (1992), http://www.sec.gov/divisions/investment/guidance/icreg50-92.pdf.

That should come as little surprise. The comprehensive regulatory scheme embodied in the ICA, the requirement of independent and informed trustees, the SEC's aggressive monitoring of standards of independence and disclosure, and competition have all combined to promote shareholder welfare and constrain costs. The SEC regularly monitors conditions in the mutual fund markets, publishes disclosure and conduct guidelines,

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[10] *Kalish* v. *Franklin Advisers, Inc.*, 742 F. Supp. 1222 (S.D.N.Y. 1990); *Meyer* v. *Oppenheimer Mgmt. Corp.*, 715 F. Supp. 574 (S.D.N.Y. 1989); *Krinsk* v. *Fund Asset Mgmt., Inc.*, 715 F. Supp. 472 (S.D.N.Y. 1988); *Schuyt* v. *Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962 (S.D.N.Y. 1987).

and when appropriate, engages in rulemaking to protect investors with respect to management and advisory fees. In recent years, for example, the Commission has adopted rules that effectively increase the statutory minimum requirement of 40% independent trustees to 75% by conditioning certain exemptive orders on meeting the higher threshold. 17 C.F.R. §270.0-1(a)(7); 17 C.F.R. §270.12b-1(c). The SEC also adopted rules that oblige mutual funds to disclose "the material factors and the conclusions with respect to those factors that formed the basis for the board's approval of advisory contracts," and to do so with "adequate specificity." SEC, Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies (June 23, 2004), http://www.sec.gov/rules/final/33-8433.htm. Finally, competitive forces appear to have rendered resort to §36(b) infrequent and unnecessary, as the SEC has observed. Mem. from Paul F. Roye, Dir. of SEC Div. of Inv. Mgmt., to SEC Chairman William H. Donaldson, at 6 (June 11, 2003), http://financialservices.house.gov/media/pdf/061803kanememo.pdf ("[E]mpirical evidence suggest[s] that there is significant competition based on costs in the fund industry.").

Thus, contrary to petitioners' claim, further "percolation" is clearly appropriate. Pet. 32. In the event this issue arises with some frequency in the future (unlike now), the academic debate ripens into a genuine dispute over legal standards that affect outcomes (which has yet to occur), and other courts of appeals actually address the issue, this Court may consider further review. But, at this point, review would clearly be premature.

II. THERE IS NO CONFLICT WITH *DAILY INCOME FUND*

The decision below does not conflict with this Court's decision in *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984). See Pet. 23-24. *Daily Income Fund* did not ad-

dress the standard for determining whether there was a breach of fiduciary duty under §36(b). Instead:

> The question for decision [was] whether Rule 23.1 of the Federal Rules of Civil Procedure requires that an investment company security holder *first make a demand upon the company's board of directors* before bringing an action under §36(b) * * * .

Daily Income Fund, 464 U.S. at 524 (emphasis added). The Court focused exclusively on whether a stockholder's right to sue a recipient of compensation "derived" from the mutual fund itself—and thus was a "derivative" suit that triggered Rule 23.1—or whether the statute granted independent standing, whether or not the fund had a claim. *Id.* at 534-542. That question did not depend on the scope of an adviser's fiduciary duty with respect to compensation.

The decision below, moreover, is entirely consistent with the background discussion from *Daily Income Fund* that petitioners invoke. The decision below did not dispute that Congress enacted §36(b) to promote "reasonable" adviser fees and eliminate "excessive" ones or that, before §36(b)'s enactment, courts too often deferred to director approval. See *Daily Income Fund*, 464 U.S. at 534 n.10, 537, 540 n.12. Likewise, the court of appeals did not contest that Congress intended courts to serve as an "independent chec[k] on excessive fees." *Id.* at 541. But Congress sought to achieve those goals by imposing a fiduciary duty on investment advisers with respect to compensation. The Second Circuit has held that the receipt of compensation does not by itself violate the adviser's fiduciary duty unless fees are "so disproportionate" to services rendered that the fee falls outside the range that could result from arm's-length bargaining; and the Seventh Circuit here echoed that standard, holding that fees that are "so unusual" as to create an inference of fiduciary breach can support liability. Those

standards conflict neither with each other nor with *Daily Income Fund*. See 464 U.S. at 539 (discussing Congress's rejection of "reasonableness" standard in favor of creation of fiduciary duty).

Nor is there any conflict with the SEC's position in *Daily Income Fund*. The SEC's observations about congressional intent, the right "to recover excessive fees" under §36(b), and the impropriety of blindly deferring to board approval are all consistent with the opinion below. The court of appeals correctly reasoned that §36(b) achieves its goal, not by providing for judicial review of whether fees are "excessive" in the abstract, Pet. App. 12a, but through review to ensure that advisers do not breach their fiduciary duty with respect to compensation. Moreover, the SEC cannot possibly agree with petitioners' view that courts should compare mutual-fund fees to those charged to pension funds and other dissimilar institutional clients. Since §36(b)'s adoption in 1970, the Securities and Exchange Commission has *never* brought an action to enforce liability for breach of an adviser's fiduciary duty with respect to compensation.

III. THE SEVENTH CIRCUIT'S APPROACH IS CORRECT

In any event, the Seventh Circuit's approach is clearly correct. Section 36(b) creates a "*fiduciary duty* with respect to the receipt of compensation" and charges plaintiffs with "the burden of proving a breach of *fiduciary duty*." 15 U.S.C. §80a-35(b) & (b)(1) (emphasis added). Unlike the open-ended excessiveness review petitioners propose, the Seventh Circuit's approach is faithful to that statutory text.

Consistent with the statutory language, the opinion below directs focus to the fund adviser's conduct. An adviser can breach its fiduciary duty, for example, through lack of candor in negotiation. Pet. App. 8a. Likewise, "a fiduciary must make full disclosure and play

no tricks." *Ibid.* But, as the court of appeals persuasively explained, "the existence of the fiduciary duty"—whether for lawyers, trustees, corporate officers, or fund advisers—"does not imply judicial review for reasonableness." Pet. App. 10a.

Petitioners object that §36(b) creates a fiduciary duty "with respect to the receipt of compensation." Pet. 21. But those words most naturally mean that advisers have a fiduciary duty when negotiating their compensation with the fund. In other words, advisers must not "pul[l] the wool over the eyes of the disinterested trustees or otherwise hinde[r] their ability to negotiate a favorable price for advisory services." Pet. App. 13a-14a. Likewise, if the fees are so unusual as to raise an inference of fiduciary breach or abdication by the fiduciary, §36(b) may be violated. See *id.* at 9a.

Petitioners' contrary interpretation—which effectively requires all fees to be "reasonable"—reads the words "fiduciary duty" out of the statute and eliminates the plaintiff's statutory "burden of proving a breach of fiduciary duty." Under petitioners' view, there is no need to prove a fiduciary breach, such as misleading conduct or bad-faith negotiation, so long as a fee can be called excessive or unreasonable compared to fees charged to other clients. But that substitutes subjectivity for statutory text. Congress could easily have authorized courts to strike down "excessive," "unreasonable," or discriminatory fees. (Indeed, precisely that language appears in a variety of regulatory statutes. See, *e.g.*, 15 U.S.C. §717c(a), (b); 47 U.S.C. §201(b).) But Congress did not do that. Congress rejected bills that would have required courts to review advisers' fees under a "reasonableness" standard. Pet. App. 10a-11a. Instead, Congress required plaintiffs to prove "*a breach of fiduciary duty*" with respect to compensation. Even the legislative history makes that clear. S. Rep. No. 91-184, at 6 (1969) (ex-

plaining that §36(b) was not intended "to introduce general concepts of rate regulation" or to allow "a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees"). Petitioners' argument is, in any event, foreclosed by the statutory text.

CONCLUSION

The petition for writ of certiorari should be denied.

Respectfully submitted.

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FEBRUARY 2009

REPLY BRIEF

120

(5)

Supreme Court
FILED
FEB 18 2009
OFFICE OF THE CLERK

No. 08-586

IN THE
Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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February 18, 2009

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An acknowledged circuit conflict now exists on the standard for determining whether an investment adviser has fulfilled its fiduciary duty "with respect to the receipt of compensation for services" under § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b). Under three circuits' approach, an investment adviser violates § 36(b) when, considering "all pertinent facts," the fee charged "is so disproportionately large" that it "bears no reasonable relationship to the services rendered." *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928-30 (2d Cir. 1982). The Seventh Circuit "disapprove[d] the *Gartenberg* approach" and held that, so long as the adviser does not "pull[] the wool over the eyes" of the fund's directors, the board's approval of the adviser's compensation "is conclusive" and the adviser may "accept" whatever the board "agrees to pay." Pet. App. 8a-9a, 14a. In rejecting the prevailing *Gartenberg* standard, the court below created significant confusion on a question of undeniable importance for today's investment sector.[1] Respondent's attempts to deny the conflict and to minimize the decision's importance through a series of deflections are unpersuasive.

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[1] This Court often grants certiorari when the court below divides evenly in denying rehearing en banc. *See, e.g., Wright v. West*, 505 U.S. 277, 284 (1992); *ETSI Pipeline Project v. Missouri*, 484 U.S. 495, 499 (1988); *Cornelius v. NAACP Legal Def. & Educ. Fund, Inc.*, 473 U.S. 788, 796 (1985).

ARGUMENT

I. THE DECISION BELOW CONFLICTS WITH DECISIONS OF OTHER CIRCUITS

A. Respondent argues (at 13-14) that the circuits articulate similar "formulations" of the governing standard. It bases that assertion on one sentence, in which the panel suggested that "[i]t is *possible* to *imagine* compensation so unusual that a court will infer that deceit must have occurred," such as where "a university's board of trustees decides to pay the president *$50 million* a year, when no other president of a comparable institution receives more than *$2 million*." Pet. App. 9a (emphases added). But the Seventh Circuit's speculation that one might be able to "*imagine*" inferring a fiduciary breach where an adviser's compensation is *25 times* the next-highest-paid adviser's is not the *Gartenberg* standard in different words. Rather, it is a new standard, under which the size of an adviser's fee would be relevant only in the most egregious, hypothetical case.

Furthermore, respondent's repeated comparisons (at 16, 29) of the phrases "so unusual" (Pet. App. 9a) and "so disproportionate[]" (*Gartenberg*, 694 F.2d at 928) miss a fundamental question – unusual or disproportionate in comparison to what? Under *Gartenberg*, the question is whether the adviser's fee "bears [a] reasonable relationship to *the services rendered*." *Id.* (emphasis added). In the Seventh Circuit, no such comparison between fees and services is relevant. Rather, the board's acceptance of the fee is presumptively fair unless the disparity reaches 25 times or more the next-highest-paid adviser's. The *Gartenberg* court, however, expressly rejected making compensation paid by other mutual funds the sole benchmark under § 36(b). It "dis-

agree[d]" with the district court's conclusion that "the principal factor" is "the price charged by other similar advisers to funds managed by them" and held that "[r]eliance on prevailing industry advisory fees will not satisfy § 36(b)." *Id.* at 929.

Respondent's counsel elsewhere acknowledges that the decision below "poses *a real and substantial conflict* with the *Gartenberg* standard."[2] According to respondent's lawyers, the decision below "*expressly rejected* the widely applied Gartenberg standard for assessing advisers' liability for excessive fees," "*erased*" "*Gartenberg's* 'proportionality' test and the 'factors' that *Gartenberg* established for measuring compliance with that test," and "erected a *new standard*." Litigation Alert at 1 (emphases added). Like respondent's counsel, at least five Seventh Circuit judges and academic commentators recognize that the court below created a circuit conflict. *See* Pet. App. 35a, 42a-43a (Posner, J., dissenting from denial of rehearing en banc); Law Professors *Amicus* Br. 2, 6-7, 11-12; 6 Thomas Lee Hazen, *Law of Securities Regulation* § 20.9[1] (6th ed. 2009) ("The Seventh Circuit takes a different approach than the cases coming out of the Second Circuit."); *see also* Pet. App. 8a ("disapprov[ing]" *Gartenberg*).

B. As Judge Posner concluded, "an important difference" (Pet. App. 41a) between the decision below and *Gartenberg* is that the Seventh Circuit's rule gives no weight to discrepancies between fees paid by an adviser's captive funds and fees paid by its independent clients for comparable services, *see id.* at 13a. Respondent does not dispute that it charged

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[2] Ropes & Gray, *Appeals Court Rejects Mutual Fund Excessive Fee Claims, Adopting New Standard for Evaluation of Fees* 2 (May 20, 2008) ("Litigation Alert") (emphasis added).

the Oakmark funds more than twice what it charged independent investors.[3] But it claims (at 19-21) higher costs to serve the funds, justifying dramatically higher prices.

The courts below made no such finding. The panel "thr[ew] out some suggestions" (Pet. App. 39a (Posner, J.)) – "[d]ifferent clients call for different commitments of time" and "[m]utual funds may grow or shrink quickly," allegedly "complicat[ing] an adviser's task." *Id.* at 13a. But, as Judge Posner explained, such "airy speculation," lacking "an evidentiary or empirical basis," cannot justify the fee differential. *Id.* at 39a, 41a. The district court's offhand statement that respondent provided "more limited" services to its independent clients than to the funds was equally speculative and insufficient to justify summary judgment against petitioners. *Id.* at 16a.

The record refutes the speculation that differences in services account for vastly higher fees charged to the funds. The evidence showed that respondent furnished substantively identical services to its institutional and fund clients and that it cost respondent significantly *more* to serve its institutional clients. *See* C.A. App. A143-A145.[4] That evidence, which

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[3] The "breakpoints" – fee reductions as assets increase – that respondent touts (at 24) are meaningless, because the funds still paid more than twice what respondent's independent clients paid for comparable services. *See* Pet. 6 & n.2.

[4] The petition's statement, which respondent cites (at 20), that "it cost Harris significantly less to serve the institutional clients," Pet. 27 (emphasis omitted), was plainly a typographical error, as the record citation following that statement demonstrated. *See* C.A. App. A145 (citing evidence establishing that "an examination of all of Harris's costs shows that Harris's institutional business is *more costly* to Harris than the Funds in

is not available in all cases, makes this case an especially good vehicle for resolving the question presented.

Respondent relies (at 20) on *Gartenberg*'s statement that fees charged to "large pension funds" could not be compared to "advisory fees for money market funds." 694 F.2d at 930 n.3. But the funds here are not money market funds, which resemble "a bank account" in that money can be invested for "as little as a day." *Id.* at 925; *see* Pet. 16 n.5. And the undisputed evidence showed that the portfolio compensation and daily management of respondent's mutual funds and its independent accounts were virtually the same. *See* C.A. App. A143-A144. Nothing in *Gartenberg* supports rejecting a comparison between the funds and independent accounts in this case, as five Seventh Circuit judges recognized. *See* Pet. App. 41a (Posner, J.). Other courts agree. *See, e.g.*, *Hunt v. Invesco Funds Group, Inc.*, No. H-04-02555, 2006 WL 1581846, at *3 (S.D. Tex. June 5, 2006); *Strigliabotti v. Franklin Res., Inc.*, No. C 04-00883 SI, 2005 WL 645529, at *3-*4 (N.D. Cal. Mar. 7, 2005).[5]

Respondent also cites a journal article claiming that many services provided to mutual funds are not furnished to institutional accounts. *See* Opp. 2, 20-

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relationship to assets under management") (emphasis added). Notably, respondent cites no contrary evidence.

[5] *Strougo v. BEA Associates*, 188 F. Supp. 2d 373 (S.D.N.Y. 2002), incorrectly refused to consider a comparison with institutional clients, reasoning that "[i]t has been held that relevant comparison [sic] must be to other mutual funds, not to non-mutual fund institutional clients," *id.* at 384. *Strougo* cited only *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962 (S.D.N.Y.), *aff'd*, 835 F.2d 45 (2d Cir. 1987) (per curiam), which involved the "unique" context of money market funds, *id.* at 983.

21 (citing John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 185 (2007) ("Coates & Hubbard")).[6] But the record shows that the funds pay separate fees for those services pursuant to separate agreements. *See* C.A. App. A143-A144. The advisory fees here are for pure portfolio-management services, *see id.*, which allows for the apples-to-apples comparison the article advocates, *see* Coates & Hubbard 186.

C. Respondent does not seriously dispute that the Third and Fourth Circuits follow *Gartenberg*. True, *Migdal v. Rowe Price-Fleming International, Inc.*, 248 F.3d 321 (4th Cir. 2001), "did not adopt *Gartenberg* wholesale," Opp. 21, because it failed to consider other circumstances the Second Circuit found relevant in determining an adviser's compliance with its fiduciary duty under § 36(c). *Compare Migdal*, 248 F.3d at 327, *with Gartenberg*, 694 F.2d at 929-30; *see* Pet. 18. But that lower-court confusion only underscores the need for this Court's review.

Respondent also observes (at 22) that *Krantz v. Prudential Investments Fund Management LLC*, 305 F.3d 140 (3d Cir. 2002), did not cite *Gartenberg*. But respondent does not contest that *Krantz* applied *Migdal*, which in turn rested on *Gartenberg*. Because the decision below focuses on whether the funds' board was "decei[ved]" (Pet. App. 9a) and does not permit an examination of "the relationship between

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[6] The article was funded in part by the mutual-fund industry and co-authored by an expert witness for investment advisers in § 36(b) cases. *See* Coates & Hubbard 151 n.aa1; *cf. Exxon Shipping Co. v. Baker*, 128 S. Ct. 2605, 2626 n.17 (2008) ("declin[ing] to rely on" research that was "funded in part by" a party to the case).

the fees charged and the services rendered by the investment adviser" (*Migdal*, 248 F.3d at 327; *Krantz*, 305 F.3d at 143 (quoting *Migdal*)), it conflicts with the Third and Fourth Circuits' standard.

II. THIS CASE IS AN IDEAL VEHICLE TO RESOLVE THIS IMPORTANT QUESTION

A. Respondent erroneously contends (at 22-25) that this case is an inappropriate vehicle because petitioners would lose under any standard. Petitioners presented ample evidence warranting a trial under a proper standard, *see* Pet. 26-29, and respondent does little to contest that proof.

Respondent claims (at 5-6, 23) that the funds performed well for a three-year period ending in 2004, but ignores that, for the three-year period ending August 31, 2006, which includes almost all of the damages period, the Oakmark Fund was one of the poorest performers in its class and earned a Morningstar Rating of only one star. *See* C.A. App. A127. Regardless, § 36(b) imposes a fiduciary duty with respect to "compensation," not performance. Focusing on the latter would turn § 36(b) into Rule 10b-5, so that poorly performing funds would then be correspondingly vulnerable to suit – a result benefiting neither investment advisers nor investors.

Respondent also asserts (at 21 n.7, 22-24) that the district court denied petitioners' claims under the *Gartenberg* standard. But, while purporting to apply *Gartenberg*, the district court in fact articulated a standard quite similar to the panel's erroneous decision below. Ignoring Congress's finding that "the forces of arm's-length bargaining do not work in the mutual fund industry," S. Rep. No. 91-184, at 5 (1969), the district court granted summary judgment based on its belief that the evidence "indicate[d] that

the board as a whole was operating without any conflict that would [have] prevent[ed] it from engaging in arm's-length negotiations" and because Harris's fees were comparable to those paid by other mutual funds. Pet. App. 30a-32a.

In rejecting the relevance of the lower rates charged to independent clients for comparable services, the district court posited "a range of prices that investors were willing to pay" that "extended from a low-end figure below what the institutional clients were paying and a high-end figure beyond the fees that other mutual fund clients paid." *Id.* at 30a. That incorrect analysis would render the independent-client comparison irrelevant in *every* case: if the range of acceptable prices extends beyond what other mutual funds pay, then it does not matter whether independent clients paid lower fees for comparable services – the higher fees charged to the mutual funds will always be upheld. And the district court's reasoning would make excessive fees the norm – defeating § 36(b)'s purpose – because "[t]he governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide." *Id.* at 41a (Posner, J.).[7]

Respondent further claims (at 24-25) that petitioners opposed *Gartenberg* below. Petitioners asserted that a trial under a properly understood *Gartenberg* standard was appropriate, while opposing misinterpretations of *Gartenberg* positing that fund perform-

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[7] The en banc dissenters' statement that the result here "*may be* correct," Pet. App. 42a (emphasis added), does not suggest they thought it *was* correct. Those judges properly viewed the case as warranting further review and recognized the panel's reasoning to be "weak," "one-sided," and based on "airy speculation." *Id.* at 41a-43a.

ance is paramount. Regardless, in resolving the circuit conflict, the Court will not be limited to any prevailing circuit's approach but instead will articulate the rule that best comports with the statute's text, structure, and history.

B. Respondent contends (at 26-27) that the circuits' different standards do not matter in practice, citing a supposed lack of reported decisions in which plaintiffs have prevailed under § 36(b). But legal rules matter in ways not necessarily reflected in published judicial opinions.

A survey of reported cases would not reveal the extent to which a legal standard motivates defendants to settle factually unfavorable cases. *Gartenberg* has led to "notable settlements wherein defendants have agreed to a prospective reduction in the fee schedule." James D. Cox et al., *Securities Regulation* 1211 (3d ed. 2001). In *Hunt* and *Strigliabotti*, the courts denied defendants' motions to dismiss, and the parties subsequently dismissed the cases with prejudice,[8] indicating settlement. Both courts recognized that a difference between fees charged to mutual funds and fees charged to independent clients for comparable services supports a § 36(b) claim. *See Hunt*, 2006 WL 1581846, at *3; *Strigliabotti*, 2005 WL 645529, at *3-*4. The cases therefore would have come out differently under the Seventh Circuit's standard, which does not permit that comparison. *See* Pet. App. 13a.[9]

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[8] *See* Memorandum and Order, *Hunt v. Invesco Funds Group, Inc.*, No. H-04-02555 (S.D. Tex. Jan. 29, 2007); Stipulation and Order Dismissing Case, *Strigliabotti v. Franklin Res., Inc.*, No. C 04-00883 SI (N.D. Cal. Aug. 9, 2007).

[9] Respondent suggests (at 11, 26) that the question presented is not frequently litigated, but its counsel elsewhere acknowledges that at least "a dozen" cases raising issues "identical" to

Furthermore, the difference in standards implicates primary, private conduct. Respondent does not dispute that, "[f]or advisers and funds in the Seventh Circuit," the panel's "holding could influence the periodic fee-approval process between advisers and independent boards." Litigation Alert at 2; *see* Pet. 31. Whereas the *Gartenberg* standard requires advisers to furnish, and directors to review, information on a variety of factors, the decision below requires only that the adviser not "pull[] the wool over the eyes of the disinterested trustees." Pet. App. 14a.[10]

Respondent also asserts (at 27, 30) that an absence of enforcement activity by the Securities and Exchange Commission means that § 36(b) is never violated. But respondent ignores the more obvious inference that the SEC has devoted its limited resources to other priorities. SEC inaction only underscores the importance of private suits, which "provide a necessary supplement to the Commission's own enforcement authority." Brief for the SEC as Amicus Curiae in Support of Affirmance at 2, *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984) (No. 82-1200).

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those involved here have been litigated in just "the past several years," with plaintiffs obtaining settlements in half the cases. Litigation Alert at 2; *see also* Pet. 30 n.12 (citing cases).

[10] The statement in *In re Mutual Funds Investment Litigation*, MDL No. 04-MD-15863, 2008 WL 5412407, at *15 (D. Md. Dec. 30, 2008), which respondent cites (at 16-17, 26), that *Gartenberg* and the decision below "lead to the same place" was limited to the unusual market-timing allegations of that case. That court recognized that the Seventh Circuit had "rejected" the *Gartenberg* standard and adopted a "different" approach. 2008 WL 5412407, at *14-*15.

III. THE COURT OF APPEALS MISINTERPRETED THE ACT

Respondent claims (at 30-31) that the decision below is grounded in § 36(b)'s text. But the panel did not base its holding on any analysis of the statutory language. *See* Pet. App. 8a-9a. On the contrary, it poured its preferred economic outcome – abdication to "market[]" forces, *id.* at 7a-8a – into the phrase "fiduciary duty" in § 36(b). And it ignored Congress's conclusion that the conflicts of interest inherent in the fund-adviser relationship require an "independent check[] on excessive fees." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 541 (1984).

The panel's conclusion that a fiduciary may accept whatever compensation is agreed on is palpably incorrect. "If the amount of compensation provided by the terms of the trust is or becomes unreasonably high or unreasonably low, the court may allow a smaller or larger compensation." *Restatement (Third) of Trusts* § 38 cmt. e (2001); *see* Pet. 25. Moreover, as the en banc dissenters recognized, "unreasonable compensation" – including fees twice those charged to independent clients for comparable services – "can be evidence of a breach of fiduciary duty." Pet. App. 41a-42a (Posner, J.). Although other evidence may also establish fiduciary breaches, § 36(b) requires more than that the adviser refrain from "pull[ing] the wool over" the trustees' eyes (*id.* at 14a) or charging fees more than 25 times the next-highest-paid adviser's (*id.* at 9a). Because the question presented raises a significant and recurring issue in an economic climate in which confidence in the securities industry is at a low ebb, this Court's imposition of the correct standard is urgently needed.

CONCLUSION

The petition for a writ of certiorari should be granted.

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February 18, 2009

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Supreme Court, U.S.
FILED
DEC 3 - 2008
OFFICE OF THE CLERK

114 (3)

No. 08-586

IN THE
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On Petition for Writ of
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INTEREST OF *AMICI CURIAE*[1]

AARP is a non-partisan, non-profit organization with more than 40 million members, working and retired, dedicated to addressing the needs and interests of people aged 50 and older. Through education, advocacy, and service, and by promoting independence, dignity, and purpose, AARP seeks to enhance the quality of life for all. As one method of promoting independence, AARP attempts to foster the economic security of individuals as they age by seeking to increase the availability, security, equity, and adequacy of public and private retirement plans. In this regard, AARP has a longstanding interest in the operations of mutual fund and other investment vehicles because of the critical role they play in helping ensure financial security in retirement. A considerable amount of AARP's work in this area has focused on combating fraudulent practices in the nation's securities industry due to the fact that older people are frequent victims of such fraud. AARP has regularly commented on legislative and regulatory

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[1] Counsel for *amici curiae* complied with Sup. Ct. R. 37.2 by notifying counsel for the parties of the intent to file this brief more than ten days prior to the brief's due date. Counsel for Petitioner's letter granting blanket consent to the filing of *amicus curiae* briefs was docketed on November 6, 2008, and consent from counsel for Respondent has been filed with this brief. Pursuant to Rule 37.6 of the Court, *amici* state that no counsel for any party authored this brief in whole or in part, and no person or entity other than *amici* and their counsel contributed monetarily to this brief 's preparation or submission.

proposals that address investment fraud and opposed efforts to limit the remedies available to defrauded investors.

In addition to concerns about the effects of fraud on retirees' economic security, AARP also is dedicated to ensuring, to the greatest extent possible, that people seeking to augment the retirement income they expect from Social Security can make informed decisions among the myriad available choices. AARP's advocacy and consumer education activities in these areas are informed by the many studies it has undertaken over the years to understand investors' knowledge, behaviors, and concerns. Due to their affect on investment returns, much of this research has involved fees and other costs associated with various investment options. *See, e.g.*, Sandy Mackenzie, AARP Pub. Pol'y Inst., *Determining Whether 401(k) Plan Fees are Reasonable: Are Disclosure Requirements Adequate?* (Sept. 2008), *available at* http://assets.aarp.org/rgcenter/econ/i8_fees.pdf; AARP, *Comparison of 401(k) Participants' Understanding of Model Fee Disclosure Forms Developed by the Department of Labor and AARP* (Sept. 2008), *available at* http://assets.aarp.org/rgcenter/econ/fee_disclosure.pdf; AARP, *401(k) Participants' Awareness and Understanding of Fees* (July 2007), *available at* http://assets.aarp.org/rgcenter/econ/401k_fees.pdf; *AARP, Investor Perceptions and Preferences Toward Selected Stock Market Conditions and Practices: An AARP Survey of Stock Owners Ages 50 and Older* 21 (Mar. 2004), *available at* http://www.assets.aarp.org/rgcenter/econ/investor.pdf. These studies show that

investors often lack basic knowledge of how investment vehicles operate and are unaware of key important features of their own investments.

These findings are of particular concern given the entry of many first-time investors into the market and the responsibility they have had to assume for choosing the funds into which to invest due to the shift from traditional defined benefit pension plans (in which employers bear the risk of loss) to defined contribution retirement plans (under which plan participants bear the risk of loss). Integrity in the securities markets and adherence to fiduciary duties by various actors on whom investors rely are more important than ever. AARP thus has testified before congressional committees and filed comments in response to agency rulemaking proceedings on these critical issues. *See, e.g.*, Hearing on U.S. Dep't of Labor's Proposed Reg. Under Section 408(b)(2) of ERISA (2008) (statement of David Certner, AARP Legislative Counsel and Legislative Policy Dir.) (on file with AARP) (testifying concerning fee disclosures to retirement plan fiduciaries); Letter from David Certner, AARP Dir. of Fed. Affairs, to The Hon. John Boehner, Chairman, H. Comm. on Educ. and the Workforce (June 15, 2005) (on file with AARP) (expressing concerns about H.R. 2830, The Pension Protection Act, and H.R. 2831, The Pension Preservation and Portability Act of 2005).

Consumer Federation of America (CFA) is a non-profit association of 300 consumer groups, which in turn represent more than 50 million individuals.

CFA advances the consumer interest through research, education, and advocacy. As increasing numbers of people have come to rely on the nation's financial markets to fund their retirement and invest their savings, CFA has made enhancing investor protections a top legislative and regulatory priority. CFA's policies in this area are based on a fundamental belief that investors are entitled to a marketplace that provides them with a choice of appropriate investments and service providers, the information necessary to make informed choices, protection against fraud and abuse, and effective remedies when they are defrauded. For nearly two decades, CFA has been a leader in efforts to promote investor protection legislation and regulations, and to oppose efforts to weaken those protections, at the state and federal levels. One of CFA's particular areas of concern has been the ability of investors to seek legal redress for their losses. Toward these ends, CFA has conducted research, testified before Congress, participated in Securities and Exchange Commission (SEC) roundtables, and consulted with members of Congress, SEC Commissioners, and state securities regulators.

AARP and CFA have filed *amicus curiae* briefs in cases involving the construction and application of federal securities laws. *See, e.g., Stoneridge Investment Partners, LLC v. Scientific-Atlanta*, 128 S. Ct. 761 (2008) (AARP & CFA); *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71 (2006) (AARP); *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005) (AARP & CFA); *SEC v. Edwards*, 540 U.S. 389 (2004) (AARP); *SEC v. Zandford*, 535

U.S. 813 (2002) (AARP & CFA). AARP also has filed briefs in numerous cases involving the duties of various fiduciaries involved in pensions and other retirement plans. *See, e.g.*, *LaRue v. DeWolff, Boberg & Assocs.*, 128 S. Ct. 1020 (2008); *Varity Corp. v. Howe*, 516 U.S. 489 (1996).

AARP and CFA respectfully submit that the petition should be granted because the Seventh Circuit's analysis squarely contradicts the realities of the mutual fund market, particularly how the relationship between mutual funds and their investment advisers overrides traditional market forces that otherwise might ensure that advisers' compensation was consistent with their fiduciary duty. Mutual fund investors face significant risks if the Seventh Circuit's fiduciary standard is allowed to stand. The retirement security of millions of investors will be affected by the Court's decision, as more people than ever are investing in mutual funds, on their own and through employer-sponsored 401(k)s and similar plans, and expenses associated with inflated investment adviser fees get passed on to all of them. As discussed below, the U.S. Department of Labor has found that 401(k) fees would be substantially lower with more transparent disclosure to beneficiaries, showing that employers are picking funds that charge higher fees than efficient markets would produce, contrary to the Seventh Circuit's decision. The Court should resolve the Circuit conflict created by the ruling below so that the retirement security of millions of investors will not depend on the Circuit in which they happen to reside.

SUMMARY OF ARGUMENT

Congress passed the Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq., due to "its concern with 'the potential for abuse inherent in the structure of investment companies.'" *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (citing *Burks v. Lasker*, 441 U.S. 471, 480 (1979)). The Act was ineffective in accomplishing Congress' goal of minimizing conflicts of interest and, more than four decades later, the Court noted a report commissioned by the Securities and Exchange Commission (SEC) which "found that the structure of the [mutual fund] industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation." *Id.* at 537 (citation omitted). While Congress responded to ongoing conflicts of interest between funds and their advisers by imposing a fiduciary duty on advisers with respect to their compensation, Investment Company Amendments Act of 1970, 15 U.S.C. § 80a-35(b) ("§ 36(b)"), little has changed in the ensuing years.

Yet, the Seventh Circuit has crafted a standard to determine whether an investor has proved a breach of fiduciary duty that ignores the persistent conflicts of interest that fail to adequately monitor adviser compensation levels. The lower court also based its decision on its view of a market that simply does not exist. Rather, the mutual fund market does not benefit from the economies of scale or competition that otherwise would operate to regulate adviser compensation and benefit investors. As discussed below, the U.S. Department of Labor,

the SEC, the Government Accountability Office, and numerous scholars and industry analysts all have documented the factors that drive inflated compensation levels and how even slight increases harm the millions of investors relying on mutual fund investments for their retirement security.

Congress' creation of a fiduciary duty and a private right to enforce it has to mean more than that Congress intended to allow market forces to determine whether investment advisers had fulfilled their duty. The Seventh Circuit's decision, if allowed to stand, will do just that, and AARP and Consumer Federation of America thus urge the Court to grant the petition for *certiorari*.

ARGUMENT

I. THE SEVENTH CIRCUIT'S DECISION FLIES IN THE FACE OF THE REALITIES OF HOW MUTUAL FUNDS OPERATE.

A. The Mutual Fund Industry Has Inherent Conflicts of Interest That Drive Investment Adviser Compensation.

The Seventh Circuit discussed, but then ignored the implications of, a fundamental feature of mutual fund companies that differentiates them from other corporations and undermines the court's reasoning.

> A mutual fund is an investment company that buys a portfolio of securities selected by a professional investment adviser to meet a specified financial goal. . . . Mutual funds have officers and directors or trustees. In this way, mutual funds are like any other type of operating company . . . . Unlike other companies, however, a mutual fund is typically externally managed: it is not an operating company and it has no employees in the traditional sense. Instead, a fund relies upon third parties or service providers, either affiliated organizations or independent contractors, to invest fund assets and carry out other business activities.

Inv. Co. Inst., *2008 Investment Company Fact Book*, App. A: How Mutual Funds and Investment Companies Operate 162-64 (48th ed. 2008), *available at* http://www.icifactbook.org/pdf/2008_factbook.pdf [hereinafter *ICI Fact Book*].[2]

This Court, other federal courts, and Congress have recognized the unique nature of this structure and, most importantly, its potential dangers. As this

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[2] Founded in 1940, the Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs).

Court stated:

> [m]utual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, [called 'investment advisers,'] that are separately owned and operated. . . . The advisers select the funds' investments and operate their businesses. . . . Since a typical fund is organized by its investment adviser which provides it with almost all management services . . ., a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy."

Burks v. Lasker, 441 U.S. 471, 480-81 (1979) (citations omitted).

Like other corporations, a mutual fund is headed by a board of directors and, while the board is authorized to operate the fund, it primarily plays an oversight role and is not usually involved in the fund's day-to-day management. *ICI Fact Book*, *supra*, at 166. That role is typically played by the fund's investment adviser, which often was its initial sponsor and shareholder, as well. The investment adviser is a professional money manager that "also

provides a level of money management expertise beyond the scope of the average individual investor. The investment adviser has its own employees . . . who work on behalf of the fund's shareholders and determine which securities to buy and sell in the fund's portfolio." *Id.* The adviser works for and is paid by the fund and thus "may have interests other than maximizing the returns to shareholders in the fund." *Chamber of Commerce of the U.S. v. SEC*, 412 F.3d 133, 136 (D.C. Cir. 2005). The Second Circuit recognized that

> [t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects it portfolio and administers its daily business. Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser.

Galfand v. Chestnutt Corp., 545 F.2d 807, 808 (2d Cir. 1976). *See also Role of Indep. Dirs. of Inv. Cos.*, Securities Act Release No. 33-7754 [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,212, at 82,451 (Oct. 14, 1999) (stating "Mutual funds are unique . . . in that they are 'organized and operated by people whose primary loyalty and pecuniary

interest lie outside the enterprise.'").

Congress passed the Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq., "because of its concern with the 'potential for abuse inherent in the structure of investment companies.'" *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (citing *Burks*, 441 U.S. at 480). In an effort to "minimize such conflicts of interest, Congress established a scheme that regulates most transactions between investment companies and their advisers." *Id.* Unfortunately, Congress' goals were not achieved.

> In the years following passage of the Act, investment companies enjoyed enormous growth, prompting a number of studies of the effectiveness of the Act in protecting investors. One such report, commissioned by the SEC, found that investment advisers often charged mutual funds higher fees than those charged the adviser's other clients and further determined that the structure of the industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation.

Id. at 537 (citation omitted).

The SEC later noted that investment advisers' compensation typically was based on a set percentage of the fund's assets, not on services performed or expenses incurred. As a result, "as a fund's assets grew, this form of payment could

produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio." *Id.* (citation omitted). Moreover, the Commission found that investor lawsuits "challenging the reasonableness of adviser fees had been largely ineffective due to the standards employed by courts to judge the fees." *Id.* (citation omitted). In a further effort to remedy the innate conflicts at play, Congress passed the Investment Company Amendments Act of 1970 which, in part, imposed a fiduciary duty on investment advisers with respect to their compensation and created a private right of action. 15 U.S.C. § 80a-35(b) ("§ 36(b)").

Congress acted in response to the fact that decades after it passed the original Act those conflicts remained. Unfortunately, little has changed in the ensuing years. As Judge Posner stated in his dissent from the panel's denial of a petition for rehearing, the majority "bases its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 730 (7th Cir. 2008) (Posner, J., dissenting). He also noted that connections between mutual fund industry agents "'foster favoritism, to the detriment of investors. Fund directors and advisory firms that manage funds hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by

the board less intensively.'" *Id.* at 731 (citation omitted). *See also* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 609, 672 (2001) [hereinafter *The Cost of Conflicts of Interest*] (stating that "the gap between prices charged funds for advisory services versus prices fetched elsewhere in the economy for those same services represents the bill paid by fund shareholders for the advisory conflict of interest that is both the fund industry's hallmark and its stigma. That tab runs into billions of dollars per year.").[3]

The Seventh Circuit remains willing to maintain the status quo, leaving investors subject to these ongoing conflicts of interest and inefficient

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[3] *See also In re Banc One Inv. Advisors Corp.*, Assurance of Discontinuance Pursuant to Exec. Law § 63 (15) at 11-12, 15 (June 29, 2004), *available at* http://www.oag.state.ny.us/media_center/2004/jun/jun29d_04_attach.pdf (settlement of case alleging mutual fund adviser permitted unlawful excessive market timing activity in several of its mutual funds included, among other relief, $40 million in reduced management fees to be charged to investors over five-year period and commitment to hire full-time senior officer to ensure fees charged by funds are negotiated at arms' length and are reasonable); *In re AIM Advisors, Inc.*, Assurance of Discontinuance Pursuant to Exec. Law § 63 (15) at 6, 12, 14-16 (Oct. 7, 2004), *available at* http://www.oag.state.ny.us/media_center/2004/sep/sep7c_04_attach2.pdf (in settling case alleging two mutual fund management companies allowed illegal market timing, companies agreed to reduce advisor fees by $75 million over five years and to hire a full-time senior officer who will manage the process by which management fees are negotiated so that they are negotiated at arms' length and are reasonable).

market forces. *Amici* submit, however, that Congress' creation of a compensation-related fiduciary duty and an investor's right to enforce it has to mean something other than that Congress was content to allow market forces to determine whether investment advisers had breached their duty.

B. The Seventh Circuit Based Its Ruling on Faulty Premises About Market Forces in the Mutual Fund Industry.

The Seventh Circuit's standard for proving breach of an investment adviser's compensation-related fiduciary duty failed to recognize the inefficiencies endemic to the market and assumed a level of competition that simply does not exist.[4] In fact, the Seventh Circuit's assumptions conflict with Congress' findings when it enacted § 36(b) in 1970, and federal agency findings since then, that fees are not set in a perfectly competitive world. For example, in its recent rulemaking proceeding with respect to required fiduciary disclosures in participant-directed individual retirement accounts

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[4] The court also erred in basing its standard of proof on the notions that a "fiduciary must make full disclosure and play no tricks," and that "Plaintiffs do not contend that Harris Associates pulled the wool over the eyes of the disinterested trustees . . . ." *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632, 635 (7th Cir. 2008). The court's emphasis on the absence of bad acts is misplaced, as § 36(b) specifically provides: "It shall not be necessary to allege or prove that any defendant engaged in personal misconduct . . . ." 15 U.S.C. § 80a-35(b)(1).

(e.g., 401(k)s)[5], the U.S. Department of Labor noted that "plan participants on average pay fees that are higher than necessary by 11.3 basis points per year." U.S. Dep't of Labor, Employee Benefits Sec. Admin., "Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans," 73 Fed. Reg. 43014, 43020 & n.13 (proposed July 23, 2008) (to be codified at 29 C.F.R. pt. 86) [hereinafter "DOL Fiduciary Requirements"]. DOL believes that other research into the distribution of investor expense levels makes this estimate conservative, and notes that it "does not take into account less visible expenses such as mutual funds' internal transaction costs . . . which are sometimes larger than funds' expense ratios."[6] *Id.* at n.13. Moreover, in evaluating what underlies this variation, the Department found that "a significant proportion of the variation in plan fees is due to market inefficiencies." *Id.* at 43020.

The Seventh Circuit also failed to take into account another characteristic of the mutual fund

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[5] This rulemaking only applies to participant-directed plans but is significant to the Court's ruling because mutual fund ownership has grown sharply through workplace retirement plans; in 2007, 33 million households held mutual funds through such plans. Inv. Co. Inst., *Trends in Ownership of Mutual Funds in the United States, 2007*, Research Fundamentals 1 (Nov. 2007), *available at* http://www.ici.org/pdf/fm-v16n5.pdf [hereinafter *ICI Trends in Ownership*].

[6] The expense ratio is the cumulative total of fees and expenses charged to the fund for a particular period shown as a percentage of its net assets.

market, namely that investors do not benefit from reduced adviser compensation that would be expected to result from the economies of scale that exist in the market.

> The concept of 'economies of scale' assumes that as a mutual fund increases in size, its operational costs decrease proportionally. If a fund realizes economies of scale, its willingness to let the shareholders participate in the resulting benefits becomes a factor in evaluating the reasonableness of the adviser-manager's fees. Section 36(b) of the Act was specifically directed to economies of scale.

Kalish v. Franklin Advisers, Inc., 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990). As the *Kalish* court noted, § 36(b) was addressed at a problem identified by the SEC, that ""advisers' fees, generally stated as a percentage of the market value of the managed assets, which had been altogether reasonable when a fund was launched, may have become unreasonably high when the fund grew to enormous size."" *Id.* at 1237-38 (quoting *Fogel v. Chestnutt*, 668 F.2d 100, 111 (2d Cir. 1981), *cert. denied*, 459 U.S. 828 (1982). *See also Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 326-27 (4th Cir. 2001) (stating "Section 36(b) was enacted in large part because Congress recognized that as mutual funds grew larger, it became less expensive for investment advisers to provide the additional services. Congress wanted to

ensure that investment advisers passed on to fund investors the savings they realize from these economies of scale.").

As previously discussed concerning conflicts of interest, however, Congress' goals have not been realized with respect to investors' benefitting from the savings resulting from economies of scale. The General Accounting Office has noted that "[b]ecause mutual funds are expected to operate more efficiently as their assets grow, the significant asset growth in recent years has prompted concerns about fund fee levels." U.S. Gov't Accounting Office, *Mutual Fund Fees – Additional Disclosure Could Encourage Price Competition*, Report to the Chairman, Subcomm. on Fin. and Hazardous Materials and the Ranking Member, House Commerce Comm. 4 (June 2000) [hereinafter *GAO Mutual Fund Fees*]. Unfortunately, "GAO was unable to determine the extent to which the growth in mutual fund assets during the 1990s provided the opportunity for mutual fund advisers to reduce fees," due to the fact that "information on most fund advisers' costs is not collected by regulators or otherwise publicly disclosed." *Id.* at 5-6. GAO did conclude, however, that "the revenue fund advisers and other service providers collect as fees from the mutual funds they operate appears to have increased significantly. . . . As mutual fund assets have grown, the revenues that fund advisers and other service providers collect through the fees they deduct from these funds have also risen." *Id.* at 42.

Another analysis of adviser fees noted

"fiduciary-managers' seeming ability to reap large rewards by not sharing costs savings with shareholders," and found that while

> administrative expenses have dropped as fund size has grown, it is unclear whether there is robust price competition in the market for the most critical service offered by the fund to its shareholders: professional management. . . . Investment advice is essentially a commodity. Outside the fund industry, it is bought and sold in a much more competitive marketplace. Active portfolio management essentially is a mental process. It principally involves deciding which securities to buy and sell in order to maximize returns. The process is scalable, in that it is equally applicable to large and small portfolios. . . . [T]he fundamental management process is essentially the same for large and small portfolios, as well as for pension funds and mutual funds.

The Cost of Conflicts of Interest, *supra*, at 627-28. *See also* Robert Barker, *High Fund Fees Have Got to Go*, Bus. Wk., Aug. 16, 1999, at 122 (stating that "[v]ast economies of scale benefited mutual-fund companies, not investors."); Thomas Easton, *The fund industry's dirty secret: Big is not beautiful*, Forbes, Aug. 24, 1998, at 116, 117 (noting that while size is an advantage in most businesses, "[i]n mutual

funds it is an advantage only to the sponsor, not to the customer.").

Another fallacy of the Seventh Circuit's reasoning is its assumptions about competition in the mutual fund marketplace and its effect in regulating adviser compensation. In fact, the GAO found that the form and style of "competition in the mutual fund industry appear to resemble the type of market referred to by economists as 'monopolistic competition.' Although thousands of mutual funds appear to compete actively for investor dollars, this competition has not focused primarily on the price of the service -- i.e, fees charged to shareholders." *GAO Mutual Fund Fees*, *supra*, at 56.

II. THE SEVENTH CIRCUIT'S STANDARD FOR ESTABLISHING § 36(b) LIABILITY WILL HARM MILLIONS OF INVESTORS WHO DEPEND ON MUTUAL FUND EARNINGS FOR THEIR RETIREMENT SECURITY.

A. Individuals Are Investing in Mutual Funds in Record Numbers.

Demographic factors have led to considerable changes in participation in the nation's securities markets. Historically, wealthy individuals and corporations were the primary investors in the stock market. That is no longer true, due to the combined effect of the baby boom generation's entry into adulthood, changes in retirement regulations and strategies, and a stock market that, until recently,

produced high returns. We now live in an era in which Social Security provides proportionately less of needed retirement income, and traditional employer-sponsored defined benefit pension coverage has decreased significantly. In addition, during the last two decades more and more people have shifted their savings from bank accounts to money market mutual fund accounts.

A recent Investment Company Institute (ICI) survey of the mutual fund industry showed that the combined assets of the nation's mutual funds totaled $10.631 trillion in September 2008. Inv. Co. Inst., *Trends in Mutual Fund Investing*, Sept. 2008, *available at* http://www.ici.org/stats/mf/trends_09_08.html#TopOfPage. The ICI also reported that as of the end of last year, approximately 88.2 million individual investors, in an estimated 50.6 million households, or about 43.6% of all U.S. households, owned mutual funds. *ICI Trends in Ownership*, *supra*, at 2.

The increased number of individuals purchasing mutual funds is due, in large part, to the significant trend toward replacing defined benefit plans with defined contribution plans. Approximately 45 million U.S. households own mutual funds in tax-deferred accounts, such as 401(k)s and other defined contribution plans, more than own funds outside these accounts. *Id.* at 5. "About two-thirds of households that own mutual funds through tax-deferred accounts hold funds in employer-sponsored retirement plans. . . . . The growth of fund ownership through workplace

retirement plans has been largely fueled by the shift from traditional pensions to defined contribution plans, many of which offer mutual funds as investment options." *Id.* at 6. In 2007, 33 million households held mutual funds through such plans, up from 27 million in 1998. *Id.* at 6-7. This increased reliance on defined contribution plans places significant responsibility on individuals to make appropriate investment choices so they will have sufficient retirement income. With so many people relying on mutual funds to fund their retirement, they face a heightened risk not merely if the funds in which they invest perform poorly, but also if they pay unnecessary, or unnecessarily high, fees and other expenses.

B. Investment Advisers' Inflated Compensation Causes Significant Harm to Investors.

While individuals are investing in mutual funds in greater numbers than ever, many for the first time, they remain largely unaware of the various fees and other expenses that their funds charge, all of which reduce their earnings.[7] For

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[7] While much of this discussion focuses on 401(k) plan participants, it is highly relevant to the issue before the Court due to the high number of 401(k) participants who invest in mutual funds. *See ICI Fact Book*, *supra*, at 91 (noting that at the end of 2007, $1.7 trillion of 401(k) assets were invested in mutual funds, and mutual funds' share of the 401(k) market rose from 9% in 1990 to approximately 55 % at the end of 2007). In addition, for most plans, investment fees, such as those charged by mutual fund advisors, account for the largest

example, in a recent survey of 401(k) participants aged 25 and older, when asked whether they pay any fees for their 401(k) plan, nearly two in three (65%) participants reported that they pay no fees and only about one in six (17%) said they do pay fees. AARP, *401(k) Participants' Awareness and Understanding of Fees* 5 (July 2007), *available at* http://assets.aarp.org/rgcenter/econ/401k_fees.pdf. After being told that 401(k) plan providers often charge fees for administering their plans, the vast majority (83%) admitted not knowing how much they pay in fees and expenses associated with their own plans. *Id.* In addition, 54% said they do not feel knowledgeable about the long-term impact fees can have on their total retirement savings. *Id.* at 6. *See also* AARP, *Comparison of 401(k) Participants' Understanding of Model Fee Disclosure Forms Developed by the Department of Labor and AARP* 26 (Sept. 2008) *available at* http://assets.aarp.org/rgcenter/econ/fee_disclosure.pdf (stating that most plan participants do not know how much they are paying in fees and expenses for their 401(k) plans, and half are unable to perform the basic math necessary to convert basis points into dollars).

Despite this lack of knowledge of fees and

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portion of total fees. A "2005 industry survey estimated that investment fees made up about 80 to 99 percent of plan fees . . . ." *See* U.S. Gov't Accountability Office, *Private Pensions – Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees* 2, Report to the Ranking Minority Member, House Comm. on Educ. & the Workforce (Nov. 2006) [hereinafter *GAO Private Pensions Changes Needed*].

expenses, investors are trying to make smart decisions to ensure, to the greatest degree possible, that they will have invested sufficiently, and earned a high enough return, to achieve their retirement goals. Yet, the effect of inflated fees is more than merely academic.

> Whether the fees that 401(k) plans charge are fair or reasonable is a vital issue for working Americans and their families. . . . For the sake of their retirement security, participants in 401(k) plans . . . must also earn a respectable rate of return on their investments. Excessively high fees can eat into the accumulating balance of a plan participant, and cause the income that the balance can sustain in retirement to be much lower than it should be. . . . Excessive fees can jeopardize retirement security even when financial market performance is satisfactory.

Sandy Mackenzie, AARP Pub. Pol'y Inst., *Determining Whether 401(k) Plan Fees Are Reasonable: Are Disclosure Requirements Adequate?* 1 (Sept. 2008), *available at* http://assets.aarp.org/rgcenter/econ/i8_fees.pdf. The Government Accountability Office recently noted that fees are among the many factors 401(k) participants should consider when investing because fees can significantly decrease retirement savings over the course of an employee's career. Even "a 1-percentage

point difference in fees can significantly reduce the amount of money saved for retirement," had that amount remained in the account to be reinvested. *See GAO Private Pensions Changes Needed*, *supra*, at 7. *See also* U.S. Dep't of Labor, Employee Benefits Sec. Admin., *Understanding Retirement Plan Fees and Expenses* 2 (May 2004), *available at* http://www.dol.gov/ebsa/pdf/undrstndgrtrmnt.pdf (stating that the "cumulative effect of fees and expenses on retirement savings can be substantial."); *GAO Mutual Fund Fees*, *supra*, at 28 (same, and "studies have also documented the impact of fees on investors' returns by finding that funds with lower fees tended to be among the better performing funds."); "DOL Fiduciary Requirements," *supra*, at 43031 (noting that "[k]ey determinants of the return on an investment include the fees and expenses paid.").

CONCLUSION

The Seventh Circuit not only created a split in the Circuits, but in divorcing its decision from the realities of how the mutual fund industry operates, the appeals court created a standard for determining breach of fiduciary duty under § 36(b) that will potentially harm millions of individuals relying on such funds for their retirement security. AARP and

CFA respectfully urge the Court to grant the petition for *certiorari*.

December 3, 2008

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AMICUS CURIAE BRIEF

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No. 08-586

Supreme Court, U.S.
FILED
DEC 3 - 2008
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IN THE
Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF *AMICI CURIAE* LAW PROFESSORS IN SUPPORT OF THE ISSUANCE OF A WRIT OF CERTIORARI

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December 3, 2008

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INTEREST OF *AMICI CURIAE*[1]

Amici are established scholars[2] at American law schools whose research and teaching interests focus on federal securities regulation, business organizations, and the law of investment funds. *Amici* have no financial stake in the outcome of this case but are interested in ensuring a uniform and coherent interpretation of the Investment Company Act of 1940 (the "Company Act"). We file this brief to urge this Court to grant the petition and to clarify the proper scope of the fiduciary duty that investment advisers owe to fund shareholders with respect to the compensation that advisers receive. We are prompted to submit this brief because the decision in this case will have wide-ranging consequences for millions of American investors and the trillions of dollars they entrust to these fiduciaries.

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[1] No counsel for any party has authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. Counsel of record for all parties received notice of *amici curiae*'s intention to file this brief at least 10 days prior to the due date. *See* Sup. Ct. R. 37.2(a). Counsel for Petitioners filed a letter with the Clerk granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of Respondent to the filing of this brief has been filed with the Clerk. *See id.*

[2] A full list of *amici*, who join this brief as individuals and not as representatives of any institutions with which they are affiliated, is set forth in the Appendix to this brief.

SUMMARY OF ARGUMENT

In its ruling below, the United States Court of Appeals for the Seventh Circuit boldly discarded more than a quarter-century of jurisprudence and substituted in its place an imaginative economic reinterpretation of Section 36(b) of the Investment Company Act of 1940 that elides a critical provision of the statute. In so doing, the court of appeals undermined a key bulwark safeguarding the interests of the ninety million U.S. shareholders of mutual funds, a thirteen-trillion-dollar industry[3] uniquely vulnerable to conflicts of interest and uncommonly impoverished in protective market forces.

Indeed, so striking was this replacement of congressional legislation with only superficial market theory to support it that Judge Richard Posner, one of the foremost judicial and scholarly proponents of economic analyses of law, called the reasoning "one-sided" and "ripe for reexamination" when dissenting from the denial of rehearing en banc. Pet. App. 43a, 37a.

Critical to understanding this case is the fact that mutual funds differ from typical corporations in several important structural ways. These differences explain both why, contrary to the court of appeals' reasoning, the market alone fails to ensure competitive fees and why Congress in the Company Act imposed a fiduciary duty on investment advisers to protect shareholders from excessive fees.

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[3] *See* Investment Company Institute, *2008 Fact Book* 7 (48th ed. 2008) ("*ICI 2008 Fact Book*"), *available at* http://www.icifactbook.org. In addition to the savings of individuals, mutual funds also hold trillions of dollars in tax-deferred savings from 401(k), 403(b), and pension plans. *See id.* at 8-9.

The central participants in the mutual fund field are investment advisers, businesses whose profession is to manage pools of investors' money. Unlike the typical purveyor of professional services, who must win customers in the open market, however, an investment adviser has the ability to create its own clients by forming the very mutual funds to which it provides its services. More importantly for the issues in this dispute, the investment adviser also has the power to appoint the clients' overseers: the board of directors.[4] When the adviser forms a mutual fund, it appoints and thereafter controls the reappointment of the fund's board. Because the investment adviser owns all the fund's shares at this nascence, it has the luxury of appointing whomever it wishes to these positions.[5]

One of the first tasks of the then-newly constituted board is to sign the advisory agreement pursuant to

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[4] Alternatively, if the entity is a business trust, as most mutual funds are, a board of trustees will govern it.

[5] The composition of the board must, however, comport with certain federal requirements. For instance, the Company Act requires that "no more than 60 per centum" of the board may be "interested persons" of the fund; that is, they may not be affiliated with the investment adviser. Company Act §§ 10(a), 2(a)(19), 15 U.S.C. §§ 80a-10(a), 80a-2(a)(19). As a matter of practice, however, most mutual funds obligate themselves to meet a higher threshold of board independence because, in exchange for doing so, Securities and Exchange Commission ("SEC") regulations provide widely sought exemptive relief from onerous restrictions on how the funds may operate. *See, e.g.*, Company Act Rule 12b-1(c), 17 C.F.R. § 270.12b-1(c) (permitting funds to charge a distribution fee – known as a "12b-1 fee" – provided they satisfy the fund governance standards of Company Act Rule 0-1(a)(7), 17 C.F.R. § 270.0-1(a)(7), which require, *inter alia*, that at least 75 percent of the trustees be independent).

which the fund pays the investment adviser to manage the assets of the fund. Not surprisingly, mutual fund boards retain the investment advisers that founded the fund (and practically never fire them). The intimate reciprocity involved in the process of approving the compensation for the advisers in their roles as outsourced executives – albeit ones who own and operate all of the fund's operational infrastructure – explains Congress's "concern with the potential for abuse inherent in the structure of investment companies," which this Court has noted twice when previously considering the Company Act. *Daily Income Fund, Inc. v. Fox*, 464 U.S 523, 536 (1984) (quoting *Burks v. Lasker*, 441 U.S. 471, 480 (1979)) (internal quotation marks omitted).

The ongoing incestuous relationship between the fund and its founding adviser is what prompted Congress to enact the Investment Company Act of 1940 and, more notably, the Investment Company Amendments Act of 1970. The goal of both statutes was to ameliorate the unchecked power of advisers to charge their funds, given that "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." S. Rep. No. 91-184, at 5 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4901.[6] One of Congress's most important attempts to address this structural deficiency was the addition in 1970 of Section 36(b) to the Company Act, which provides that "the investment adviser of a registered investment company shall be deemed to have a fidu-

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[6] *See also* Tamar Frankel, *Advisory Fees: Evolving Theories*, 10 Inv. Law. 22 (2003) (noting the historical transformation of investment advice from an eleemosynary profession to a profit-driven business).

ciary *duty with respect to the receipt of compensation for services.*" 15 U.S.C. § 80a-35(b) (emphasis added).

Twelve years later, in 1982, the Second Circuit explicated the content of Section 36(b) in *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), a seminal ruling that has dominated professional, judicial, and regulatory understandings of the fiduciary duty for more than twenty-five years, until now. In *Gartenberg*, the Second Circuit held that, "to be guilty of a violation of § 36(b), . . . the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Id.* at 928. As further guidance, the court enumerated a menu of factors that a board might consider in evaluating the excessiveness of an investment advisory agreement. *Id.* at 930.[7]

Over the past quarter-century, *Gartenberg* has borne ever more weight as the foundation of a sprawling edifice of compliance for Section 36(b). Not only have dozens of courts – including the Third and Fourth Circuits – adopted the *Gartenberg* standard in deciding Section 36(b) cases, but the SEC has endorsed and encoded the *Gartenberg* standards in regulations and disclosure requirements,[8] while the

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[7] These *Gartenberg* factors include (1) "rates charged by other advisers of similar funds," (2) "the adviser-manager's cost in providing the service," (3) "the nature and quality of the service," (4) "the extent to which the adviser-manager realizes economies of scale as the fund grows larger," and (5) "the volume of orders which must be processed by the manager." *Gartenberg*, 694 F.2d at 929-930.

[8] *See, e.g.*, Form N-1A, Items 5, 21 & 22(d)(6), 17 C.F.R. §§ 239.15A, 274.11A (requiring fund boards to disclose whether

industry itself has developed a *soi-disant* "*Gartenberg* process," involving the preparation of lengthy reports that compare fund fees and performance for the annual approval of advisory contracts. Most importantly, *Gartenberg* shapes the advice counsel provides boards of trustees in their annual review of advisory contracts. Indeed, *Gartenberg* is the basis for much of what transpires in the boardrooms of the nearly nine thousand registered investment companies.

In its recent ruling, the Seventh Circuit explicitly discarded the precedent and practice of *Gartenberg*. In doing so, it created a harmful split of authority in the courts of appeals. The court introduced an entirely new interpretation of Section 36(b) by ignoring a critical provision of the statute and by asserting that the mutual fund market "come[s] much closer to the model of atomistic competition than do most other markets." Pet. App. 12a. The court cited no authority for this observation. Relying on this conjecture of salutary competition, the court casually "disapprove[d] the *Gartenberg* approach," concluding that the substantive and procedural components of the fiduciary duty were largely irrelevant. *Id.* at 8a. Instead, the court held that, so long as an adviser "make[s] full disclosure" and "play[s] no tricks," a plaintiff cannot prevail on a Section 36(b) claim. *Id.* The court declined to explain why Congress would enact Section 36(b) to accomplish such a result when securities statutes and regulations prohibiting un-

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they discussed the *Gartenberg* factors in approving investment advisory contracts and, if not, why not); Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Investment Company Act Release No. 26,486, 83 SEC Docket 261, § II.B n.31 (June 23, 2004) ("2004 SEC Release") (citing, with approval, the *Gartenberg* approach).

faithful conduct already existed, or what the phrase "with respect to the receipt of compensation for services" in the statute might mean. 15 U.S.C. § 80a-35(b).

This Court should grant the petition for a writ of certiorari to resolve the split of authority between the Seventh Circuit and the Second, Third, and Fourth Circuits and to delineate the proper degree to which the content and scope of the Section 36(b) fiduciary duty and other corporate fiduciary duties may be abdicated in favor of the panacean forces of free-market competition.

REASONS FOR GRANTING THE PETITION

I. THE COURTS OF APPEALS HAVE TAKEN CONFLICTING AND IRRECONCILABLE APPROACHES TO THE FIDUCIARY DUTY CREATED BY SECTION 36(b)

In its opinion below, the Seventh Circuit considered and consciously departed from the analysis of the Second Circuit, stating, "[W]e now disapprove the *Gartenberg* approach." Pet. App. 8a. In doing so, the court swerved away not just from the *Gartenberg* opinion but also from the rulings of *all* other courts of appeals that have analyzed Section 36(b), from the position and regulations of the administrative agency charged with the interpretation and enforcement of Section 36(b), and, indeed, from the well-established practice of investment advisers and boards of trustees.

A. The *Gartenberg* Ruling Has Been Adopted by All Other Courts of Appeals To Rule on This Question

The Second Circuit established the dominant interpretation of Section 36(b) when it ruled on a claim by shareholders of a money market fund that the

fund's investment adviser, Merrill Lynch, charged fees that were "so disproportionately large as to constitute a breach of fiduciary duty in violation of § 36(b)." *Gartenberg*, 694 F.2d at 925.

In its analysis, the Second Circuit relied upon the provision's legislative history in construing both a substantive and a procedural element to the Section 36(b) fiduciary duty. The duty could be violated substantively if the adviser charged a fee so large that it "bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Id.* at 928. The court then elaborated upon a process by which trustees – and courts – could make this substantive determination: "all pertinent facts must be weighed." *Id.* at 929. The pertinent facts have since become well known in both jurisprudence and practice as the "*Gartenberg* factors"; they are

(1) the nature and quality of services provided to fund shareholders;

(2) the profitability of the fund to the adviser-manager;

(3) fall-out benefits;

(4) economies of scale;

(5) comparative fees structures; and

(6) the independence and conscientiousness of the trustees.

Id. at 927-934; *see also Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409 (2d Cir. 1989) (citing and expanding upon *Gartenberg*).

The Second Circuit pointedly noted that the procedure of evaluating these factors, while necessary to discharging the Section 36(b) fiduciary duty, would not alone be sufficient to satisfy the duty. *Garten-*

berg, 694 F.2d at 930. "[E]ven if the trustees of a fund endeavored to act in a responsible fashion, an adviser-manager's fee could be so disproportionately large as to amount to a breach of fiduciary duty in violation of § 36(b)." *Id.* In other words, *Gartenberg* establishes that faithfully discharging the Section 36(b) fiduciary duty requires two independent and necessary elements – one substantive, one procedural.

The Fourth Circuit endorsed the "exhaustive[] analy[sis]" of Section 36(b) contained in *Gartenberg* and adopted the Second Circuit's approach unreservedly when evaluating the claims of two shareholders in funds advised by T. Rowe Price who sued the adviser for breaching its fiduciary duty under Section 36(b). *See Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 326-328 (4th Cir. 2001). The court agreed that, "in order to determine whether a fee is excessive for purposes of Section 36(b), a court must examine the relationship between the fees charged and the services rendered by the investment adviser." *Id.* at 327.

Shortly thereafter, when confronted with a very similarly situated set of plaintiffs to those in *Migdal*, the Third Circuit turned to the *Migdal* opinion – and the rationale therein, which the Fourth Circuit had adopted from *Gartenberg* – as "the case on which [the court] primarily rel[ied] to reach [its] conclusion." *Krantz v. Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140, 145 (3d Cir. 2002).[9] Thus, with slightly

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[9] Both Judge Posner in his dissent from denial of rehearing en banc and Petitioners have pointed out that the Third Circuit's ruling in *Green v. Fund Asset Management, L.P.*, 286 F.3d 682 (3d Cir. 2002), is inapposite to this line of cases because, in *Green*, "the amount of [the adviser's] compensation was not at issue." Pet. App. 35a; Pet. 19.

varying emphases upon the factors to consider, the Fourth and Third Circuits have adopted the *Gartenberg* analysis.

B. The SEC Has Accepted and Implemented the *Gartenberg* Approach

In ways both explicit and implicit, the SEC has also accepted the approach for complying with Section 36(b) set forth in *Gartenberg* and has encoded regulatory provisions that oblige investment advisers to do the same. For example, in a 2004 release, the SEC promulgated rule and form amendments requiring disclosure in proxy statements and annual shareholder reports of the approval process for mutual fund advisory contracts. The SEC also listed five "specific factors" to be discussed, citing *Gartenberg* and noting that "[c]ourts have used similar factors in determining whether investment advisers have met their fiduciary obligations under Section 36(b)." 2004 SEC Release § II.B n.31. The SEC's approval process stands in stark contrast to the market-based approach embraced by the court of appeals in this case.

The new amendments imposed by the SEC included a revision of Schedule 14A of the Securities Exchange Act of 1934 (the "Exchange Act") to require a discussion of the *Gartenberg* factors in proxy statements distributed to the shareholders of investment companies or, if a mutual fund board concludes that any factor "is not relevant to the board's evaluation of the investment advisory contract for which approval is sought, [the board must] note this and explain the reasons why that factor is not relevant." Schedule 14A, Item 22(c)(11), 17 C.F.R. § 240.14a-101.

The amendments also revised Form N-1A[10] to require similar discussions of the *Gartenberg* factors in prospectuses and statements of additional information provided to mutual fund shareholders. *See* Form N-1A, Items 5(a)(1)(iii) & 22(d)(6).

C. The Seventh Circuit's Ruling Sharply Breaks with *Gartenberg* and the SEC

In remarkable contrast to the *Gartenberg* line of cases and the SEC's position, the Seventh Circuit's decision eviscerated the substantive limits that Section 36(b) places upon fees and eliminated entirely a fiduciary's need to engage in any process to determine compensation. The court of appeals instead asserted that investment advisers are "not subject to a cap on compensation." Pet. App. 8a. And, although one might "imagine compensation so unusual that a court will infer that deceit must have occurred," even such a windfall would be acceptable if "similar institutions" imposed similar fees. *Id.* at 9a. As Judge Posner pointed out in voting for rehearing, when excessive fees are "industry-wide," then those fees "become the industry's floor," not its ceiling, and would presumably pass muster under the Seventh Circuit's new standard. *Id.* at 41a.

Under the Seventh Circuit's new rule, the process by which an adviser's compensation is determined would also be irrelevant provided a fiduciary "make[s] full disclosure and play[s] no tricks." *Id.* at 8a. If the Seventh Circuit believed it was putting an end to the "federal judiciary [acting as] a rate regula-

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[10] Corresponding revisions were also made to Form N-2 for closed-end funds and Form N-3 for separate accounts offering variable annuity contracts. *See* Form N-2, Item 9.1.b(4), Instructions 6.e & 6.f to Item 23; Form N-3, Item 6(b)(iii), Instructions 6(v) & 6(vi) to Item 27(a).

tor," its ruling was a solution in search of a problem. *Id.* at 14a. In fact, since the enactment of Section 36(b)'s fiduciary duty thirty-eight years ago, no federal court has ever set a rate "after the fashion of the Federal Energy Regulatory Commission" as the Seventh Circuit apparently feared. *Id.*[11]

The Seventh Circuit's reasoning thus overlooks the substantial value of the *Gartenberg* factors: namely, their healthy impact on the behavior of the fund's trustees in their mandated annual reviews of the advisory contract. *Gartenberg* has positively stimulated procedural protection for shareholders during the renewal of investment advisory contracts. The board, with its independent counsel, systematically reviews the advisory contract through the lens of the *Gartenberg* factors.

Moreover, with a similar lawsuit currently pending in the Eighth Circuit and the possibility of the circuit split hardening or fracturing further,[12] this case provides the Court with an excellent opportunity to clarify the Section 36(b) fiduciary duty and to develop the more robust economic reexamination that Judge Posner believes is warranted by "the creation of a circuit split, the importance of the issue to the mutual fund industry, and the one-sided character of the panel's analysis." *Id.* at 42a-43a.

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[11] *See* James D. Cox et al., *Securities Regulation: Cases and Materials* 1211 (3d ed. 2001).

[12] *See Gallus v. Ameriprise Fin., Inc.*, Civil No. 04-4498 (D. Minn. July 10, 2007), *appeal pending*, No. 07-2945 (8th Cir. argued Apr. 17, 2008).

II. THIS CASE PRESENTS AN EXCELLENT OPPORTUNITY TO CLARIFY THE ROLE AND RELEVANCE OF THE MUTUAL FUND MARKET IN ASSESSING VIOLATIONS OF AN ADVISER'S FIDUCIARY DUTY

With its focus fixed clearly upon the alleged difference between the competitiveness of the mutual fund industry in 1970 and today, the Seventh Circuit has largely ignored the important liminal question whether it or any court may depart from the statutory obligations imposed by Congress in Section 36(b) to address supposed new market conditions. If markets are to be the sole check on excessive advisory compensation, Congress must make that decision, after hearings in which theories such as those postulated by the Seventh Circuit could be advanced and appropriately met by hard evidence to the contrary. But so long as Section 36(b) remains intact – such that the fiduciary duty applies specifically "to the receipt of compensation for services" – no court has grounds to ignore this congressionally enacted language. 15 U.S.C. § 80a-35(b). Even if this Court were also inclined to elide this clause from Section 36(b), however, any frank analysis of the mutual fund market would require a more robust evaluation of the limits of competitive forces than the one sketched by the Seventh Circuit.

A. The Decision Below Ignores the Statutory Requirements of Section 36(b)

Whereas *Gartenberg* and its progeny take pains to evaluate the motivations of Congress through an examination of legislative history, the Seventh Circuit adopted a purely textualist approach, albeit one in which it ignored the critical text. The court eschewed language from the Senate report accompany-

ing the enactment of Section 36(b) as part of the Investment Company Amendments Act of 1970:

> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

S. Rep. No. 91-184, at 5, *reprinted in* 1970 U.S.C.C.A.N. 4901.[13] Refusing to accept this Court's finding of such congressional intent in *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984), and *Burks v. Lasker*, 441 U.S. 471, 480 (1979), the Seventh Circuit insisted that "Congress did not enact its members' *beliefs*; it enacted a text." Pet. App. 11a. But courts need not always sort through legislative history to draw conclusions about the purpose of a particular statutory provision. The very creation and structure of a statute can, by itself, demonstrate an animating

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[13] In several respects, the operation of mutual funds is similar to that of banks: both issue redeemable obligations to the public and use the proceeds for investments in securities (in the case of mutual funds) and loans (in the case of banks). Neither set of obligations is traded on a market; they are simply redeemed to the issuing entities. *See* 1 Tamar Frankel & Ann Taylor Schwing, *The Regulation of Money Managers* § 1.02[B][2][b] (2d ed. Supp. 2006) ("Frankel & Schwing").

intent to curb some perceived abuse, as is the case with Section 36(b).

Even if one were to accede to the Seventh Circuit's decision to focus upon only the text of Section 36(b), one must still conclude that Congress created a new and specific species of fiduciary duty. The use of the language "with respect to the receipt of compensation for services" clearly qualifies this fiduciary duty and requires an investment adviser to vouchsafe good faith, fair dealing, and the other trappings of a fiduciary specifically in conjunction with the fees it charges. 15 U.S.C. § 80a-35(b). The Seventh Circuit completely reads this language out of its analysis. Moreover, the very demand that the advisory contract be approved annually implicitly envisions evaluation of the fairness of the contract's terms. The *Gartenberg* factors at least announce minimal considerations for this mandated inquiry into fairness.

To conclude that this provision means only that a "fiduciary must make full disclosure and play no tricks," as the Seventh Circuit did, renders the provision nugatory and impotent in a regulatory regime already bristling with antifraud provisions. At the time, mutual fund advisers were specifically obliged to provide full disclosure and not to play tricks by Section 34(b) of the Company Act, 15 U.S.C. § 80a-33(b) (making unlawful any untrue statements of material fact in a registration statement or other documents); Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (making unlawful any fraud upon clients or prospective clients); Sections 11, 12, and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*, 77q (imposing civil liability for false registration statements and for noncompliant prospectuses, and making unlawful fraudulent interstate

transactions); and Section 10(b) of the Exchange Act, 15 U.S.C. § 78j(b), and Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (making unlawful the use of any manipulative or deceptive devices). The obvious implication and effect of adding Section 36(b) to this regime was to create a separate and new duty specifically designed to impose a limitation upon the compensation that fiduciaries can charge and receive.

B. The Seventh Circuit's Economic Analysis Is Ripe for Reexamination

Even assuming that the Seventh Circuit was justified in departing from the statutory text of Section 36(b), the new economic analysis the court offers of the state of competition in the mutual fund market is superficial and, as Judge Posner noted, "one-sided." Pet. App. 43a.

The nature of mutual funds and their competitiveness were not issues for decision in the Seventh Circuit; instead, the court sought out evidence of its own – finding just one study (which happened to contradict the court's disapproval of *Gartenberg*) – and deduced the remainder of its analysis. *Id.* at 12a (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 Iowa J. Corp. L. 151, 213 (2007)). The choice of this solitary study is curious given the study's singular conclusion that competition has favorably impacted fees, particularly in light of evidence that fees have risen as more entrants have appeared in the field.[14]

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[14] *See, e.g.*, John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 106-122 (2008) (critiquing the Coates-Hubbard study).

The court either did not find or chose not to discuss the contrary findings contained in a multitude of other careful scholarly studies. *See, e.g.*, John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 610 (2001); General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* (June 2000), *available at* http://www.gao.gov/archive/2000/gg00126.pdf; SEC, *Public Policy Implications of Investment Company Growth*, *reprinted in* H.R. Rep. No. 89-2337 (1966); Wharton School of Finance & Commerce, 87th Cong., *A Study of Mutual Funds* (Comm. Print 1962). The Seventh Circuit thus barely surveyed the literature and reached an erroneous understanding of the operation of the mutual fund industry. And, even allowing *arguendo* that the court's view of the industry and its market were correct, it is for Congress and not the Seventh Circuit to amend Section 36(b). Moreover, even in the absence of a rigorous, two-sided evaluation of the empirical evidence relating to competition in the mutual fund market, a fair-minded court would have many readily available reasons to avoid a credulous, laissez-faire embrace of this industry: *e.g.*, the notorious market-timing investigations that have implicated dozens of mutual fund advisers over the past five years[15]; the rigorous and widespread critique of executive compensation in popular and academic literature[16]; and the spectacular recent

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[15] *See, e.g.*, William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 Tul. L. Rev. 1401 (2006).

[16] *See, e.g.*, Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004).

collapse of the nation's lending and financial industries in which, as Judge Posner pointed out, "abuses have been rampant," Pet. App. 38a.

At a cursory glance, the sheer numbers associated with mutual funds – thousands of funds and hundreds of advisers on the supply side and millions of investors and trillions of dollars on the demand side – would seem to guarantee a robust marketplace. But, in fact, many investors "are not arriving at the agora unfettered."[17] Their choices are extremely constrained by inertia and the limited menu of options available in 401(k) and other retirement plans. Many mutual fund shareholders simply do not possess or know how to acquire the information necessary to make an informed movement of their assets.[18] In sum, as the aforementioned studies demonstrate, the mutual fund market is complex and variegated, with some sectors enjoying vigorous price competition while others are largely uncontested.[19]

Declaring that "[i]t won't do," the Seventh Circuit preemptively rejected the criticism that most investors are unsophisticated by claiming that "sophisticated investors who do shop create a competitive pressure that protects the rest." Pet. App. 12a. Of course, such an assertion would turn on the number of those sophisticated investors and the amount of their assets, but the court's reliance on institutional investors to serve as sentinels for average investors

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[17] Birdthistle, 80 Tul. L. Rev. at 1442.

[18] *Id.*

[19] *See generally* James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 Wash. U. L.Q. 907, 923 (2005) (explaining why, under current practices, investors cannot be expected to make rational choices among funds in the fashion described by the Seventh Circuit).

in mutual funds is badly misplaced. The interests of the two groups might align only if they inhabited the same space, but they do not.

First, when institutional investors invest in the same securities as average shareholders, they do not pay the same fees; institutions receive preferential mutual fund prices through specially issued institutional shares. Second, when institutional investors do pay the same or higher fees as average shareholders, they do not invest in the same securities; hedge funds and mutual funds are radically different investments with totally incompatible risk profiles. *See id.* at 13a. Curiously, the Seventh Circuit was happy to compare similar fees of unrelated investment products – such as those charged by mutual funds versus hedge funds – but unwilling to contrast divergent fees of identical investment products – such as those paid by mutual fund shareholders versus unaffiliated institutional clients.

C. This Court Should Permit Comparisons to the Fees Paid by Institutional Investors

As Judge Posner points out, if the "governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide" – or even just sector-wide – then the court's ruling would prevent plaintiffs from ever identifying an excessive fee. Pet. App. 41a. By analyzing the lower rates paid by institutional funds, which enjoy a far less structurally intertwined and captive relationship with investment advisers, a plaintiff can demonstrate how far an adviser has strayed from its Section 36(b) fiduciary duty.

Finally, the Seventh Circuit points to the specific success of the investments at issue in this case: "The Oakmark funds have grown more than the norm for

comparable pools, which implies that Harris Associates has delivered value for money." *Id.* at 6a. Here, in a rare point of agreement, Judge Posner allows that this may mean the "outcome of this case may be correct." *Id.* at 42a. Yet the Investment Company Institute, which is the advocate of investment advisers, acknowledges that only about forty percent of the industry's aggregate annual growth is due to fund performance.[20] Most of the remaining increase is due simply to growth by sales: new investments flowing into the funds. In order to evaluate whether the fees Harris charged were reasonable or excessive, then, one would need to evaluate whether the adviser was a skilled portfolio manager or merely an outstanding marketer. Only one of those talents benefits fund shareholders.[21]

This Court should use this case to clarify the proper scope of the Section 36(b) fiduciary duty that investment advisers owe to fund shareholders and to elucidate the role and relevance of the mutual fund market in evaluating that duty.

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[20] *See ICI 2008 Fact Book* 7.

[21] *See* 2 Frankel & Schwing § 12.03[C], at 69-70 (2001).

CONCLUSION

For these reasons, *amici* respectfully urge this Honorable Court to grant the petition for a writ of certiorari.

Respectfully submitted,

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JOINT APPENDIX

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No. 08-586

Supreme Court, U.S.
FILED
JUN 10 2009
OFFICE OF THE CLERK

IN THE
Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Petitioners,
v.

HARRIS ASSOCIATES L.P.,
Respondent.

**On Writ of Certiorari
to the United States Court of Appeals
for the Seventh Circuit**

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UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF MISSOURI
(Jefferson City)

No. 04-cv-4184-NKL

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DOCKET PROCEEDINGS

DATE	#	DOCKET ENTRY
8/17/04	1	COMPLAINT against Harris Associates LP (Filing fee $ 150 receipt number 220674) Service due by 12/15/2004, filed by Wm Dirk Vandever on behalf of Jerry N. Jones. (Attachments: #1 #2) (Vandever, Wm) Modified on 8/20/2004 to reflect receipt of paper exhibits in JC Clerk's Office (Russel, Jeri). (Entered: 08/17/2004)
		* * * * *
10/7/04	19	ORDER by Judge Nanette Laughrey granting in part 17 Motion for Entry of Scheduling Order. Defendant shall file a motion to transfer the action to

the Northern District of Illinois on or before October 11, 2004. Plaintiff's response is due on or before October 18, 2004, and Defendant's reply is due by October 20, 2004. The Defendant is granted an extension to November 1, 2004, to file a responsive pleading. (Text entry only – no document attached) (Kanies, Renea) (Entered: 10/07/2004)

* * * * *

10/11/04 21 MOTION to reassign/transfer case *Defendant's Motion to Transfer Action to the Northern District of Illinois* filed by Lynn S. McCreary on behalf of Harris Associates LP Suggestions in opposition/response due by 10/18/2004*, Reply Due 10/20/2004 (McCreary, Lynn) Modified on 10/12/2004 to reflect briefing schedule as ordered by the Court on 10/7/2004 Doc. 19. (Kanies, Renea). (Entered: 10/11/2004)

10/11/04 22 SUGGESTIONS in support re 21 MOTION to reassign/transfer case *Defendant's Motion to Transfer Action to the Northern District of Illinois Suggestions in Support of Defendant's Motion to Transfer Action to the Northern District of Illinois* filed by Lynn S. McCreary on behalf of Defendant Harris Associates LP. (Attachments: #1 Exhibit A – Declaration of Ann W. Regan #2 Exhibit B – Copy

of Complaint #3 Exhibit C – Copy of Nelson v. AIM Decision #4 Exhibit D – Notice of Order #5 Exhibit E – Federal Court Management Statistics for 2003) (Related document(s) 21) (McCreary, Lynn) (Entered: 10/11/2004)

* * * * *

10/18/04 24 SUGGESTIONS in opposition re 21 MOTION to reassign/transfer case *Defendant's Motion to Transfer Action to the Northern District of Illinois* filed by Becky Ferrell-Anton on behalf of Plaintiffs Jerry N. Jones, Mary Frances Jones, Olga Menyhart. Reply suggestions due by 11/2/2004 unless otherwise directed by the court (Attachments: #1 Exhibit A – Part 1 #2 Exhibit A – Part 2 #3 Exhibit B #4 Exhibit C) (Related document(s) 21) (Ferrell-Anton, Becky) (Entered: 10/18/2004)

10/20/04 25 REPLY SUGGESTIONS to motion re 21 MOTION to reassign/transfer case *Defendant's Motion to Transfer Action to the Northern District of Illinois* filed by Fred L. Sgroi on behalf of Defendant Harris Associates LP. (Attachments: #1 Exhibit A – Order in Williams v. Waddell & Reed #2 Exhibit B – Order in Fleisher v. Janus Capital) (Related document(s) 21) (Sgroi, Fred) (Entered: 10/20/2004)

* * * * *

11/1/04	30	MOTION to dismiss case *Defendant's Motion to Dismiss* filed by Fred L. Sgroi on behalf of Harris Associates LP Suggestions in opposition/response due by 11/16/2004 unless otherwise directed by the court (Sgroi, Fred) (Entered: 11/01/2004)
11/1/04	31	SUGGESTIONS in support re 30 MOTION to dismiss case *Defendant's Motion to Dismiss* filed by Fred L. Sgroi on behalf of Defendant Harris Associates LP. (Attachments: #1 Affidavit Declaration of Robert A. Skinner #2 Exhibit A to Declaration of Robert A. Skinner – Complaint #3 Exhibit B to Declaration of Robert A. Skinner – Statement of Additional Information) (Related document(s) 30) (Sgroi, Fred) (Entered: 11/01/2004)
11/16/04	32	SUGGESTIONS in opposition re 30 MOTION to dismiss case *Defendant's Motion to Dismiss* filed by Wm Dirk Vandever on behalf of Plaintiffs Jerry N. Jones, Mary Frances Jones, Olga Menyhart. Reply suggestions due by 12/1/2004 unless otherwise directed by the court (Attachments: #1 Exhibit Exhibit A1 #2 Exhibit Exhibit A2 #3 Exhibit Exhibit B #4 Exhibit Exhibit C #5 Exhibit Exhibit D #6 Exhibit Exhibit E #7 Exhibit Exhibit F) (Related document(s) 30) (Vandever, Wm) (Entered: 11/16/2004)

* * * * *

12/1/04	34	REPLY SUGGESTIONS to motion re 30 MOTION to dismiss case *Defendant's Motion to Dismiss* filed by Lynn S. McCreary on behalf of Defendant Harris Associates LP. (Related document(s) 30) (McCreary, Lynn) (Entered: 12/01/2004)

* * * * *

12/21/04	36	ORDER by Judge Nanette Laughrey. Defendant's Motion to Transfer Venue [Doc. 21] is GRANTED. This case is transferred to the Northern District of Illinois for further proceedings. (Kanies, Renea) (Entered: 12/21/2004)
12/22/04		LETTER to Northern District of Illinois regarding transfer. Includes 21 day delay information. (James, Carrie) (Entered: 12/22/2004)
1/12/05		LETTER Regarding Transfer to Northern District of Illinois after 21 day waiting period. Original paper documents transmitted. (James, Carrie) (Entered: 01/12/2005)

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DOCKET PROCEEDINGS

DATE	#	DOCKET ENTRY
11/1/04	30	MOTION by defendant to dismiss this action. (cem) (Entered: 12/30/2004)
12/28/04	37	ORIGINAL file, certified copy of transfer order, with one volume of pleadings consisting of document numbers 1 through 36, and docket sheet received from USDC WD/MO, Case No. 2:04-cv-04184-NKL; Civil cover sheet (Document 37-1 through 37-2) (cem) Modified on 12/30/2004 (Entered: 12/30/2004)
		* * * * *
1/18/05	58	Duplicate of transferred-in record received from the USDC for the West-

		ern District of Missouri, see docket entry no. 37. (Originally docketed to Case #05-CV-299 and removed pursuant to Executive Committee Order dated 03/03/05 57). (ar,) (Entered: 03/16/2005)
1/18/05	105	SUPPLEMENT to transferred case 37 (ar,) (Entered: 12/05/2005)
		* * * * *
2/22/05	49	MINUTE entry before Judge Charles P. Kocoras: Defendant's motion for leave to file over-sized brief in support of its motion to dismiss, is granted. Telephone notice. (sct,) (Entered: 02/22/2005)
		* * * * *
3/1/05	51	MOTION by Defendant Harris Associates LP to dismiss (las,) (Entered: 03/02/2005)
3/1/05	52	NOTICE of Motion by Ngozi Chigioke Okorafor-Johns for presentment of defendant's motion to dismiss 51 before Honorable Charles P. Kocoras on 4/7/2005 at 09:30 AM. (las,) (Entered: 03/02/2005)
3/1/05	53	MEMORANDUM by Harris Associates LP in Support of their motion to dismiss 51 (las,) (Entered: 03/02/2005)
3/3/05	57	EXECUTIVE COMMITTEE ORDER: ". . . It is ordered that the Clerk is to transfer the documents filed in 05-C-299 to the case file for 04-C-8305,

Jones, et al, v. Harris Associates, re-numbering such documents, if necessary, and to statistically close 05-C-299," signed by Chief Judge Charles P. Kocoras on 03/03/05. (For further detail see order). Mailed notice (ar,) (Entered: 03/16/2005)

* * * * *

3/14/05	56	MINUTE entry before Judge Charles P. Kocoras: Plaintiffs' agreed motion (Doc 54) for leave to file over-sized brief, limited to 25 pages, in response to motion to dismiss, is granted. Telephone notice. (sct,) (Entered: 03/14/2005)
3/15/05	59	MEMORANDUM by plaintiffs in Opposition to defendants motion to dismiss 51, 30 (vmj,) (Entered: 03/17/2005)
3/15/05	60	NOTICE of filing by plaintiffs re memorandum in opposition to motion to dismiss 59 (vmj,) (Entered: 03/17/2005)
3/22/05	61	REPLY memorandum by Defendant Harris Associates LP in support of defendant's motion to dismiss 30; Notice. (vmj,) (Entered: 03/24/2005)
3/22/05	62	AMENDED NOTICE of filing by Harris Associates LP re reply memorandum in support of defendant's motion to dismiss 61 (vmj,) (Entered: 03/24/2005)

4/7/05	63	MINUTE entry before Judge Charles P. Kocoras: Ruling held. Enter Memorandum Opinion: Harris's motion 30 & 51 to dismiss the complaint is denied. Defendant is given to 4/21/05 to answer the complaint. All fact discovery to be completed by 8/9/05. Status hearing set for 8/9/05 at 9:30 a.m. Mailed notice (mjc,) (Entered: 04/11/2005)
4/7/05	64	MEMORANDUM Opinion Signed by Judge Charles P. Kocoras on 4/7/2005. (mjc,) (Entered: 04/11/2005)
4/21/05	65	ANSWER to plaintiffs' Complaint by defendant, Harris Associates LP; Notice. (vmj) (Entered: 04/26/2005)
5/4/05	66	NOTICE of filing by defendants regarding stipulation and order governing confidential materials. (vmj,) (Entered: 05/09/2005)
5/6/05	67	MINUTE entry before Judge Charles P. Kocoras: Enter Stipulation and Order Governing Confidential Materials. Mailed notice (vmj,) (Entered: 05/11/2005)
5/6/05	68	STIPULATION and Order signed by Judge Charles P. Kocoras on 5/6/2005. Mailed notice (vmj,) (Entered: 05/11/2005)
5/11/05	69	AGREED MOTION by Plaintiffs for leave for plaintiffs to file an amended complaint (Attachments: #1 Amended Complaint) (gma,) (Entered: 05/12/2005)

5/11/05	70	NOTICE of Motion by Kevin Michael Flynn for presentment of AGREED MOTION by Plaintiffs for leave for plaintiffs to file an amended complaint 69 before Honorable Charles P. Kocoras on 5/16/2005 at 09:30 AM. (gma,) (Entered: 05/12/2005)
5/16/05	71	MINUTE entry before Judge Charles P. Kocoras: Plaintiffs' agreed motion 6 for leave to file an amended complaint is granted. Mailed notice Mailed notice (vmj,) (Entered: 05/17/2005)
5/16/05	72	ANSWER to plaintiffs' amended Complaint by Harris Associates LP; Notice. (vmj,) (Entered: 05/20/2005)

* * * * *

6/10/05	73	AMENDED complaint by Jerry N Jones, Mary Frances Jones, Olga Menyhart against all defendants (Attachments: #1 Exhibit Exhibit 1 #2 Exhibit Exhibit 2 #3 Exhibit Exhibit 3) (Fields, Nina) (Entered: 06/10/2005)

* * * * *

9/8/06	163	MINUTE entry before Judge Charles P. Kocoras: Joint motion 152 to file over-sized briefs of up to 35 pages is granted. Hearing on said motion set for 9/11/2006 is stricken as moot. Mailed notice (sct,) (Entered: 09/08/2006)
9/11/06	177	CONFIDENTIAL EXHIBITS 1, 4, 5, 6, 9, 10, 11, 12, 13, 24, 25, 26, 27, 28, 29, 30, 31 and 32 to the Declaration of

Brian R. Blais by Defendant Harris Associates LP (RESTRICTED) (cav,) (Entered: 09/14/2006)

9/12/06 165 MOTION by Defendant Harris Associates LP for summary judgment (Blais, Brian) (Entered: 09/12/2006)

9/12/06 166 MEMORANDUM by Harris Associates LP in Support of motion for summary judgment 165 (Blais, Brian) (Entered: 09/12/2006)

9/12/06 167 RULE 56 (b) Statement by Harris Associates LP regarding motion for summary judgment 165 (Blais, Brian) (Entered: 09/12/2006)

9/12/06 168 DECLARATION of Brian R. Blais regarding motion for summary judgment 165 by Harris Associates LP (Attachments: #1 Exhibit 1 #2 Exhibit 2 #3 Exhibit 3 #4 Exhibit 4 #5 Exhibit 5 #6 Exhibit 6 #7 Exhibit 7 #8 Exhibit 8 #9 Exhibit 9 #10 Exhibit 10 #11 Exhibit 11 #12 Exhibit 12 #13 Exhibit 13 #14 Exhibit 14 #15 Exhibit 15 #16 Exhibit 16 #17 Exhibit 17 #18 Exhibit 18 #19 Exhibit 19 #20 Exhibit 20 #21 Exhibit 21 #22 Exhibit 22 #23 Exhibit 23 #24 Exhibit 24 #25 Exhibit 25 #26 Exhibit 26 #27 Exhibit 27 #28 Exhibit 28 #29 Exhibit 29 #30 Exhibit 30 #31 Exhibit 31 #32 Exhibit 32) (Blais, Brian) (Entered: 09/12/2006)

9/12/06 169 MOTION by Plaintiffs Jerry N Jones, Mary Frances Jones, Olga Menyhart

for summary judgment (Bradley, James) (Entered: 09/12/2006)

* * * * *

9/12/06 171 RULE 56 56.1 Statement by Jerry N Jones, Mary Frances Jones, Olga Menyhart regarding motion for summary judgment 169 (Bradley, James) (Entered: 09/12/2006)

9/12/06 172 Index of Exhibits & Exhibits to Doc. # 171 Plaintiffs' Statement of Facts in Support of Plaintiffs' Motion for Summary Judgment by Jerry N Jones, Mary Frances Jones, Olga Menyhart (Attachments: #1 Exhibit A-1 #2 Exhibit A-2 #3 Exhibit A-3) (Bradley, James) (Entered: 09/12/2006)

9/12/06 173 Index of Exhibits & Exhibits to Plaintiffs' Statement of Facts in Support of Plaintiffs' Motion for Summary Judgment by Jerry N Jones, Mary Frances Jones, Olga Menyhart (Attachments: #1 Exhibit C-1 Part 1 #2 Exhibit C-1 Part 2 #3 Exhibit C-2 Part 1 #4 Exhibit C-2 Part 2 #5 Exhibit C-3 Part 1 #6 Exhibit C-3 Part 2 #7 Exhibit C-3 Part 3 #8 Exhibit C-4 Part 1 #9 Exhibit C-4 Part 2 #10 Exhibit C-4 Part 3 #11 Exhibit C-4 Part 4 #12 Exhibit C-5 Part 1 #13 Exhibit C-5 Part 2) (Bradley, James) (Entered: 09/12/2006)

* * * * *

9/12/06	175	Index of Exhibits & Exhibits to Doc. #171 Plaintiffs' Statement of Facts in Support of Plaintiffs' Motion for Summary Judgment by Jerry N Jones, Mary Frances Jones, Olga Menyhart (Attachments: #1 Exhibit G-1 #2 Exhibit G-3 #3 Exhibit G-4 #4 Exhibit G-5 #5 Exhibit H-1 #6 Exhibit H-2 #7 Exhibit H-3 Part 1 #8 Exhibit H-3 Part 2) (Bradley, James) (Entered: 09/12/2006)
9/12/06	176	Restricted Documents Pursuant to Local Rule 26.2 (Doc. #s 172, 173, 175) by Jerry N Jones, Mary Frances Jones, Olga Menyhart (Bradley, James) (Entered: 09/12/2006)
9/12/06	178	EXHIBITS by Plaintiffs (RESTRICTED) (eav,) (Entered: 09/14/2006)

* * * * *

10/10/06	188	MEMORANDUM by Harris Associates LP in Opposition to motion for summary judgment 169 (Blais, Brian) (Entered: 10/10/2006)
10/10/06	189	RESPONSE by Defendant Harris Associates LP to Rule 56 statement 171 (Blais, Brian) (Entered: 10/10/2006)
10/10/06	190	DECLARATION of Brian R. Blais regarding memorandum in opposition to motion 188 by Harris Associates LP (Attachments: #1 Exhibit 1 #2 Exhibit 2 #3 Exhibit 3 #4 Exhibit 4 #5 Exhibit 5 #6 Exhibit 6 #7 Exhibit 7 #8 Exhibit 8 #9 Exhibit 9 #10 Exhibit 10 #11

Exhibit 11) (Blais, Brian) (Entered: 10/10/2006)

10/10/06 191 MEMORANDUM by Jerry N Jones, Mary Frances Jones, Olga Menyhart in Opposition to *Defendant Harris Associates L.P.'s Motion for Summary Judgment* (Attachments: #1 Exhibit 1 #2 Exhibit 2 #3 Exhibit 3 #4 Exhibit 4 #5 Exhibit 5 #6 Exhibit 6 #7 Exhibit 7 #8 Exhibit 8) (Bradley, James) (Entered: 10/10/2006)

10/10/06 192 RESPONSE by Plaintiffs Jerry N Jones, Mary Frances Jones, Olga Menyhart to Rule 56 statement 167 *and Statement of Additional Facts Pursuant to Local Rule 56.1* (Bradley, James) (Entered: 10/10/2006)

10/10/06 193 Plaintiffs' Index of Exhibits in Support of Plaintiffs' Response to Defendant's Statement of Undisputed Facts and Plaintiffs' Statement of Additional Facts Pursuant to Local Rule 56.1 by Jerry N Jones, Mary Frances Jones, Olga Menyhart (Attachments: #1 Exhibit A-1 #2 Exhibit A-2 #3 Exhibit A-3 #4 Exhibit A-4 #5 Exhibit A-5 #6 Exhibit A-6 #7 Exhibit D-1 #8 Exhibit D-2 #9 Exhibit D-3 #10 Exhibit D-4 #11 Exhibit D-5 #12 Exhibit D-6 #13 Exhibit D-7 #14 Exhibit E #15 Appendix 1) (Bradley, James) (Entered: 10/10/2006)

10/10/06 194 CONFIDENTIAL EXHIBITS 3 and 6-11 to Harris' opposition to plain-

tiffs' summary judgment motion by Defendant Harris Associates LP. (RESTRICTED) (tlm) (Entered: 10/11/2006)

10/24/06 195 REPLY by Plaintiffs Jerry N Jones, Mary Frances Jones, Olga Menyhart to memorandum in opposition to motion 188 *for Summary Judgment* (Bradley, James) (Entered: 10/24/2006)

10/24/06 196 REPLY by Plaintiffs Jerry N Jones, Mary Frances Jones, Olga Menyhart to Response 189 *by Defendant's to Plaintiffs' Statement of Additional Facts Pursuant to Local Rule 56.1* (Bradley, James) (Entered: 10/24/2006)

10/24/06 197 Plaintiffs' Index of Exhibits in Support of Plaintiffs' Reply to Defendant's Statement of Additional Facts & Plaintiffs' Reply in Support of their Motion for Summary Judgment by Jerry N Jones, Mary Frances Jones, Olga Menyhart (Attachments: #1 Exhibit A-1 #2 Exhibit A-2 #3 Exhibit A-3 #4 Exhibit A-4 #5 Exhibit A-5 #6 Exhibit A-6 #7 Exhibit D-1 #8 Exhibit D-2 #9 Exhibit D-3 #10 Exhibit D-4 #11 Exhibit D-5 #12 Exhibit D-6 #13 Exhibit D-7 #14 Exhibit E #15 Appendix 1) (Bradley, James) (Entered: 10/24/2006)

10/24/06 198 REPLY by Defendant Harris Associates LP to memorandum in opposition to motion, 191 (Blais, Brian) (Entered: 10/24/2006)

10/24/06 199 REPLY by Defendant Harris Associates LP to Response 192 *and Plaintiffs' Statement of Additional Facts* (Blais, Brian) (Entered: 10/24/2006)

10/24/06 200 DECLARATION of Brian R. Blais regarding reply 198 by Harris Associates LP (Attachments: #1 Exhibit 1 #2 Exhibit 2 #3 Exhibit 3 #4 Exhibit 4) (Blais, Brian) (Entered: 10/24/2006)

10/24/06 201 EXHIBITS by Plaintiffs (RESTRICTED) (eav,) (Entered: 10/25/2006)

10/25/06 202 REPLY by Defendant Harris Associates LP to plaintiffs' Statement of additional facts and Excerpts of the expert testimony of Mercer E. Bullard, William C. Nygren, Thomas M. Blake and Ajay Khorana (RESTRICTED) (eav,) (Entered: 10/26/2006)

* * * * *

1/18/07 206 MINUTE entry before Judge Charles P. Kocoras: Oral argument held on 1/18/2007. Pending motions are taken under advisement. The Court will rule by mail. Mailed notice (sct,) (Entered: 01/18/2007)

* * * * *

2/27/07 208 MINUTE entry before Judge Charles P. Kocoras: ENTER MEMORANDUM OPINION: Plaintiffs' motion 169 for summary judgment is denied. Harris's motion 165 for summary judgment is granted on the entirety of Plaintiffs' complaint. Plaintiffs to take

nothing. All other pending motions are moot. All matters in controversy having been resolved, final judgment is entered in favor of the defendant and against all plaintiffs. Civil case terminated. Mailed notice (sct,) (Entered: 02/27/2007)

2/27/07 209 MEMORANDUM OPINION signed by Judge Charles P. Kocoras on 2/27/2007. Mailed notice(sct,) (Entered: 02/27/2007)

2/27/07 210 ENTERED JUDGMENT on 2/27/2007. Mailed notice(sct,) (Entered: 02/27/2007)

3/20/07 211 NOTICE of appeal by Jerry N Jones, Mary Frances Jones and Arline Winerman regarding orders 208 , 210, 209; Filing fee $455.00 paid; Receipt number 10646970 (dj,) (Entered: 03/21/2007)

* * * * *

8/18/08 228 OPINION from the USCA for the 7th Circuit; Argued 9/10/07; Decided 5/19/08 in USCA case no. 07-1624. (smm) (Entered: 08/20/2008)

8/18/08 229 CERTIFIED USCA JUDGMENT dated 5/19/08 regarding notice of appeal 211; USCA No. 07-1624. The judgment of the District Court is AFFIRMED, with costs, in accordance with the decision of this court entered on this date. (smm) Modified on 8/20/2008 (smm). (Entered: 08/20/2008)

* * * * *

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

No. 07-1624

JERRY N. JONES, ET AL.,
Plaintiffs-Appellants,

v.

HARRIS ASSOCIATES L.P.,
Defendant-Appellee.

DOCKET PROCEEDINGS

DATE	DOCKET ENTRY
3/20/07	Private civil case docketed. [07-1624] [2086184-1] Transcript information sheet due 3/30/07. Appellant's brief due 4/30/07 for Jerry N. Jones, for Mary F. Jones, for Arline Winerman. (kell)
	* * * * *
5/21/07	Filed 15c appellant's brief by Jerry N. Jones, Mary F. Jones, Arline Winerman. Disk filed. [07-1624] [0-0] (odea)
5/21/07	Filed 10c appendix by Appellant Jerry N. Jones, Appellant Mary F. Jones, Appellant Arline Winerman. [07-1624] [2105161-1] (odea)

6/18/07	Filed 15c appellee's brief by Harris Associates. Disk filed. [07-1624] [0-0] (linj)
7/6/07	Filed 15c appellant's reply brief by Jerry N. Jones, Mary F. Jones, Arline Winerman. Disk filed. [07-1624] [0-0] (josh)

* * * * *

9/10/07	Case heard and taken under advisement by panel: Chief Judge Frank H. Easterbrook, Circuit Judge Michael S. Kanne, Circuit Judge Terence T. Evans. [07-1624] [2139799-1] (kare)
9/10/07	Case argued by Ernest Young for Appellant Arline Winerman, Appellant Mary F. Jones, Appellant Jerry N. Jones, John D. Donovan for Appellee Harris Associates. [07-1624] [2086184-1] (kare)
5/19/08	Filed opinion of the court by Chief Judge Easterbrook. AFFIRMED. Chief Judge Frank H. Easterbrook, Circuit Judge Michael S. Kanne, Circuit Judge Terence T. Evans. [07-1624] [2086184-1] (hard)
5/19/08	ORDER: Final judgment filed per opinion. With costs: y. [07-1624] [2217799-1] (hard)
6/2/08	Filed 30c Petition for Rehearing and Petition for Rehearing Enbanc by Appellant Arline Winerman, Appellant Mary F. Jones, Appellant Jerry N. Jones. Dist. [07-1624] [2222590-1] (mank)

6/5/08	Sent clerk's copy of request to Appellee Harris Associates requesting 30c of their Answer to the Petition for Rehearing and Petition for Rehearing Enbanc filed by the Appellants on 6/2/08. [07-1624] [2223130-1] Answer to Petition for Enbanc Rehearing due 6/19/08 for Harris Associates. (mank)
6/19/08	Filed 30c Answer of Appellee Harris Associates to Petition for Rehearing and Petition for Rehearing Enbanc. Dist. Per order. [07-1624] [2227168-1] (mank)
8/8/08	Opinion filed DENYING Appellant Arline Winerman, Appellant Mary F. Jones, Appellant Jerry N. Jones Petition for Rehearing and Petition for Rehearing Enbanc. Circuit Judge Ripple did not participate in the consideration or decision of this case. En Banc. Chief Judge Frank H. Easterbrook, authoring judge, Circuit Judge William J. Bauer, Circuit Judge Richard D. Cudahy, Circuit Judge Richard A. Posner, dissenting, Circuit Judge John L. Coffey, Circuit Judge Joel M. Flaum, Circuit Judge Daniel A. Manion, Circuit Judge Michael S. Kanne, Circuit Judge Ilana D. Rovner, dissenting, Circuit Judge Diane P. Wood, dissenting, Circuit Judge Terence T. Evans, Circuit Judge Ann C. Williams, dissenting, Circuit Judge Diane S. Sykes, Circuit Judge John D. Tinder, dissenting. [07-1624] [2222590-1] (amyd)

8/18/08	MANDATE ISSUED AND ENTIRE RECORD RETURNED. (Contents returned: 4 vol. pleadings; 14 vol. loose pleadings; 7 vol. transcripts; 9 sealed env & 1 sealed box.) [07-1624] [2139801-1] (cove)
	* * * * *
11/7/08	Filed notice from the Supreme Court of the filing of a Petition for Writ of Certiorari. Supreme Court Case No.: 08-586. [07-1624] [2244681-1] (mank)
3/19/09	Filed order from the Supreme Court GRANTING the Petition for Writ of Certiorari. Supreme Court Case No.: 08-586. [07-1624] [2248392-1] (jame)

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[Apr. 7, 2005]

MEMORANDUM OPINION

CHARLES P. KOCORAS, Chief District Judge:

This matter comes before the court on the motion of Defendant Harris Associates, L.P. ("Harris"), to dismiss the complaint of Plaintiffs Jerry Jones, Mary Jones, and Olga Menyhart pursuant to Fed. R. Civ. Proc. 12(b)(6) for failure to state a claim. For the reasons set forth herein, the motion is denied.

BACKGROUND

The following factual recitation is derived from the allegations of the complaint, which we must accept as true for purposes of this motion. Plaintiffs are shareholders in four open-end registered investment companies managed by Harris: the Oakmark Fund, the Oakmark Equity and Income Fund, the Oakmark Global Fund, and the Oakmark International Fund ("the funds"), which in turn are part of a larger group

of funds ("the fund complex"). Harris provides investment advisory services and administrative services for the fund complex. For the first service, each fund pays Harris a fee that is based upon a percentage of the net assets of the fund. The administrative services are subject to a separate fee.

According to the complaint, Harris exacts fees from the funds that are much higher than the fees charged to other clients for the same services. Plaintiffs contend that this breaches the fiduciary duty imposed on Harris with respect to the compensation they receive from the fund complex, in violation of 18 U.S.C. § 80a-35(b). In 2003, the Plaintiffs state, the fund complex paid approximately $104.8 million more than it paid in 1993 for the same services from Harris, an almost 43-fold increase. According to Plaintiffs, Harris charges lower fees to other clients for services identical to those rendered to the funds. Plaintiffs also claim that technological improvements within the industry and savings from economies of scale allow Harris to render the services in question at a significantly lower cost than was previously possible, making the gap between the value of Harris's services and the price paid by the fund complex even greater. Finally, the complaint contains allegations regarding the mutual fund industry as a whole.

Harris contends that the complaint as a whole fails to state a violation of § 80a-35(b) and therefore moves for dismissal pursuant to Fed. R. Civ. Proc. 12(b)(6).

LEGAL STANDARD

A Rule 12(b)(6) motion to dismiss is used to test the legal sufficiency of a complaint. *Gibson v. City of Chicago*, 910 F.2d 1510, 1520 (7th Cir. 1990). In ruling on a motion to dismiss, a court must draw all reasonable inferences in favor of the plaintiff,

construe allegations of a complaint in the light most favorable to the plaintiff, and accept as true all well-pleaded facts and allegations in the complaint. *Bontkowski v. First Nat'l Bank of Cicero*, 998 F.2d 459, 461 (7th Cir. 1993); *Perkins v. Silverstein*, 939 F.2d 463, 466 (7th Cir. 1991). The allegations of a complaint "should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957). Nonetheless, in order to withstand a motion to dismiss, a complaint must allege the "operative facts" upon which each claim is based. *Kyle v. Morton High Sch.*, 144 F.3d 448, 454-55 (7th Cir. 1998). The plaintiff need not allege all of the facts involved in a claim and can plead conclusions. *Higgs v. Carter*, 286 F.3d 437, 439 (7th Cir. 2002); *Kyle*, 144 F.3d at 455. A pleading need only convey enough information that the defendant is able to understand the gravamen of the complaint. *Payton v. Rush-Presbyterian-St. Luke's Med. Ctr.*, 184 F.3d 623, 627 (7th Cir. 1999). However, any conclusions pled must "provide the defendant with at least minimal notice of the claim." *Kyle*, 144 F.3d at 455. Further, the plaintiff cannot satisfy federal pleading requirements merely "by attaching bare legal conclusions to narrated facts which fail to outline the basis" of the claim. *Perkins*, 939 F.2d at 466-67. With these precepts in mind, we turn our attention to Harris's motion.

DISCUSSION

Section 36(b) of the Investment Company Act of 1940 ("ICA"), amended in 1970 to increase the protection of investors in mutual funds and to facilitate enforcement of the protections afforded, imposes a

fiduciary duty upon advisers of mutual funds with respect to the compensation they receive in return for the services they render to the fund. 15 U.S.C. § 80a-35(b); *Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 742 (7th Cir. 2002). Cases considering the nature of the private right of action created by the statute have concluded that the duty is breached only when the fee imposed is so disproportionately excessive when compared to the services for which it pays that it could not have been achieved through the arm's-length bargaining expected from the fiduciary. *See, e.g., Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982). Not surprisingly, an examination of an alleged violation necessitates that a court take many facts into account, and the specific facts that will be pertinent, as well as the degree of importance they demand, to a proper determination can vary in different situations. *Id.* at 929.

Harris attacks the viability of the complaint on several fronts. First, it contends that Plaintiffs' references to practices within the mutual fund industry as a whole are insufficient to support a claim for breach of fiduciary duty. Second, Harris argues that the allegations that are specific to it are legally lacking. Third, it challenges the availability of a claim premised on excess profits retained by Harris. Lastly, Harris asks that we strike the request to rescind the contracts between Harris and the funds or a declaration that they were void at their inception.

Because the second argument Harris advances is the most significant one for purposes of the decision we are asked to make, we consider it first. Contrary to Harris's interpretation, the complaint does not solely advance legal conclusions or contentions devoid of factual content specifically attributable to the rela-

tionship between Harris and the funds in which the Plaintiffs invested. The central allegation of the complaint contends that, in 2003, the fund complex paid 43 times more than it had 10 years earlier for identical services from Harris. This allegation is supplemented by the assertion that other clients receive like services at significantly lower rates. In response, Harris suggests that the services received are not identical and advances many reasons why the amount charged is not outrageously disproportionate to the value of the services rendered, but each of the points they raise are defensive responses, not challenges to the legal viability of the Plaintiffs' core contention. We are in no position based on the allegations of the complaint to determine what services Plaintiffs received from Harris or how much they can fairly be worth. It is not inconceivable that the fees charged, given the exponential increase and different treatment of other clients alleged, were so disproportionate to the value of the services rendered that a violation of § 36(b) would lie. That is enough to withstand a 12(b)(6) challenge. *See Green v. Nuveen Advisory Corp.*, 186 F.R.D. 486, 491 (N.D. Ill. 1999).

Our discussion of the second ground dictates the fate of Harris's first argument. Because the allegations specific to Harris are sufficient to allow Plaintiffs' case to progress beyond the pleading stage, the allegations of practices within the industry as a whole are of no consequence to the consideration of this motion. Whether they are in the complaint or not, Plaintiffs may proceed, so we do not comment on their ability to support a claim were they the sole basis advanced in support of Plaintiffs' claim for relief.

Next, Harris challenges the Plaintiffs' ability to pursue a cause of action based on excess profits as alleged in Count II of the complaint. While Harris is certainly correct that § 80a-35(b) does not explicitly refer to excess profits, the scenario described in the complaint could indicate a setting in which Harris is retaining unearned fees. In other words, if the money Harris is receiving can be fairly characterized as a fee and it is in essence something for nothing, clearly that would represent an actionably disproportional relationship between the fees paid and the services rendered. *See Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 329 (4th Cir. 2001).[1] Thus, we cannot say that this claim is so devoid of potential merit as to warrant dismissal under Rule 12(b)(6).

Lastly, Harris takes issue with Plaintiffs' request to declare advisory agreements with Harris as void *ab initio* by disputing the availability of relief other than actual damages under the pertinent statutory section. The plain language of the statute refutes Harris's contention that the only remedy to be had is monetary. Subsection (3) clearly states that "no damages or other relief shall be granted against any person other than the recipient of [prohibited] compensation." 15 U.S.C. § 80a-35(3). The inclusion of the phrase "or other relief" establishes that damages are not the sole remedy that can be awarded. The remaining text of the subsection, upon which Harris relies to support its argument, places limitations on damage awards, but it does not indicate that only monetary relief is available. Harris's point regarding the applicability of any statute of limitations period

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[1] It goes without saying that we are not suggesting that retention of the profits at issue actually represent unearned fees, merely that they could.

is pertinent to a discussion of affirmative defenses, not to viability of the allegations pled solely within the complaint. Thus, we leave that issue for determination another day.

In sum, the factual allegations within the complaint outline the operative facts of a viable claim for breach of fiduciary duty and contains sufficient information to alert Harris to the gravamen of Plaintiffs' complaint.

CONCLUSION

Based on the foregoing analysis, Harris's motion to dismiss the complaint is denied.

/s/ CHARLES P. KOCORAS
Charles P. Kocoras
Chief Judge
United States District Court

Dated: Apr. 7, 2005

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed June 10, 2005]

AMENDED COMPLAINT

Plaintiffs, Jerry N. Jones, Mary Frances Jones, and Arline Winnerman for the use and benefit of the Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund, sue Defendant, Harris Associates L.P., and allege:

I. JURISDICTION AND VENUE

1. This action is a derivative action brought by Plaintiffs on behalf of the Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund (collectively, the "Funds") pursuant to §§ 36(b) of the Investment Company Act of 1940 ("ICA"), as amended, 15 U.S.C. §§ 80a-35(b).

2. This Court has subject matter jurisdiction pursuant to 15 U.S.C. § 80a-43, 15 U.S.C. § 80a-35(b)(5), and 28 U.S.C. § 1331.

3. Venue is proper in this judicial district pursuant to 15 U.S.C. § 80a-43 and 28 U.S.C. § 1391(b). Defendant is an inhabitant of or transacts business in this district, Defendant resides in this district, a substantial part of the events or omissions that give rise to Plaintiffs' claims occurred in this district, and/or Defendant may be found in this district.

4. All conditions precedent have been performed or have occurred.

II. BACKGROUND

5. Plaintiffs are shareholders in the Funds, which are open-end registered investment companies,[1] or mutual funds, created, sold, advised, and managed with other funds as part of a fund family or complex by Defendant and its affiliates (the "Oakmark Complex" or the "Fund Complex"). Defendant and its affiliates, as the underwriters, distributors, advisors, and control persons of the Funds, owe fiduciary and other duties to Plaintiffs and all shareholders of the funds in the Fund Complex.

6. Plaintiffs and the other shareholders of the Funds pay Defendant and its affiliates, or other third parties, fees for providing pure investment advisory services and administrative services. For the pure investment advisory services, the Funds pay Defendant a fee based on a percentage of the net assets of each of the funds in the Fund Complex. The Funds pay separate fees for some or all of the administrative services provided to the Funds by Defendant's affiliates or other third parties.

7. The pure investment advisory services Defendant provides to the Funds are identical to the

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[1] The Oakmark Global Fund closed to new investors as of December 15, 2003, but was open-ended at the time of purchase.

investment advisory services Defendant provides to other clients, such as institutional clients, and entail identical costs. In fact, the costs of advisors, analysts, research data, the physical plant, and other aspects of Defendant's investment advisory services are shared between the mutual funds and the other clients.

8. Despite the equivalence of the investment advisory services Defendant provides to the Funds and the other clients, the fees Defendant receives from the Funds for pure investment advisory services are much higher than the fees Defendant or its affiliates receive from other clients for the identical services.

Section 36(b) of the Investment Company Act of 1940

9. In 1940, Congress enacted the Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq. (the "ICA"). The ICA was designed to regulate and curb abuses in the mutual fund industry and to create standards of care applicable to investment advisors such as Defendant. In the 1960s, it became clear to Congress that investment advisors to equity mutual funds were gouging those funds with excessive fees, particularly by not taking economies of scale into account. As a result, § 36(b), 15 U.S.C. § 80a-35(b), was added to the ICA in 1970, which created a federal cause of action for breach of fiduciary duty.

10. Section 36(b) provides in pertinent part:

> [T]he investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such

> investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment advisers, or an affiliated person of such investment advisor, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect to such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. . . .

11. In the past decade, the assets managed by Defendant within the Fund Complex have grown dramatically. In 1993, the Fund Complex had $295.3 Million in average net assets. By 2003, the Fund Complex had exploded to over $11.7 Billion in average net assets, almost 40 times the assets in 1993. Meanwhile, advisory fees for the Fund Complex increased from $2.45 million (or 0.83% of assets) in 1993 to $107.3 million (or 0.91% of assets) in 2003. Accordingly, despite the Fund Complex's dramatic growth, no economies of scale or incremental savings were realized by the shareholders. Rather, fees actually grew as a percentage of assets.

12. While the assets of the Fund Complex and the fees have grown dramatically in size, the nature of the services rendered by Defendant has changed little, if at all. Indeed, advances in computing and communication technologies in the past twenty years have resulted in exponential efficiencies that have

dramatically reduced the costs of servicing mutual funds in ways Congress could not have imagined when it enacted ICA § 36(b). Nonetheless, the advisory fees paid to Defendant have grown dramatically. As a result, the advisory fees paid to Defendant (and accepted by Defendant in violation of its statutory fiduciary duties) are disproportionately large in relationship to the services rendered to Plaintiffs.

13. In addition, Defendant, in violation of its fiduciary duties to Plaintiffs, has retained excess profits resulting from economies of scale. These economies of scale are a product of the dramatic growth in assets managed by Defendant. As assets under management increase, the cost of providing services to the assets does not increase at the same rate. In fact, with very large funds, such as the Funds at issue here, the cost of servicing additional assets approaches zero, resulting in tremendous economies of scale. Accordingly, any fees received in connection with the additional assets represent almost pure profit. The excess profits resulting from these economies of scale belong to Plaintiffs and the other shareholders of the Funds.

14. The fees paid to Defendant are technically approved by the Funds' board of directors.[2] A majority of the board is comprised of statutorily presumed "disinterested" directors as that term is defined in § 10 of the ICA. Regardless of whether these presumably "disinterested" directors meet the requirements of § 10 of the ICA, there is a lack of conscien-

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[2] While the Funds at issue here are technically governed by a board of trustees rather than directors, the term "directors" is used throughout the complaint and should be read as synonymous with "trustees," as it is under the ICA. *See* 15 U.S.C. § 80a-2(a)(12).

tiousness by the directors in reviewing the advisory fees paid by the Funds. In addition, even if statutorily disinterested, the directors are in all practical respects dominated and unduly influenced by Defendant in reviewing the fees paid by Plaintiffs and the other shareholders of the Funds. In particular, Defendant does not provide the directors with sufficient information for the directors to fulfill their obligations, a factor supporting a finding that Defendant has breached its fiduciary duties.

15. Although the fees challenged in this lawsuit may appear to the Court to be very small on a shareholder-by-shareholder basis, they cause a dramatic decrease in Plaintiffs' investment returns over time. Arthur Levitt, past Chairman of the Securities and Exchange Commission ("SEC"), was critical of what he called the "tyranny of compounding high costs":

> Instinct tells me that many investors would be shocked to know how seemingly small fees can over time, create such drastic erosion in returns. . . . In the years ahead, what will mutual fund investors say if they realize too late their returns have fallen hard under the weight of compounding fees?

Arthur Levitt, Jr., Inaugural address: Costs Paid with Other People's Money, Address at Fordham University School of Law (Nov. 3, 2000), in 6 Fordham J. Corp. & Fin. L. 261, 267 (2001).

Nature of Claims

16. In this action, Plaintiffs seeks to rescind the investment advisory agreements and to recover for the Funds the total fees charged by Defendant or,

alternatively, to recover for the Funds the excess profits resulting from economies of scale wrongfully retained by Defendant and to recover other excessive compensation received by, or improper payments wrongfully retained by, Defendant in breach of its fiduciary duty under the ICA § 36(b), 15 U.S.C. § 80a-35(b). Because the conduct complained of herein is continuing in nature, Plaintiffs seeks recovery for a period commencing at the earliest date in light of any applicable statute of limitations through the date of final judgment after trial.

17. No pre-suit demand on the board of directors of the Funds is required, as the requirements of F.R.C.P. 23.1 do not apply to actions under § 36(b) of the ICA. *Daily Income Fund v. Fox*, 464 U.S. 523 (1984).

18. Plaintiffs do not allege or seek relief for any claims based upon improper market timing or late trading activity involving the Funds.

III. PARTIES

19. Plaintiffs Jerry N. Jones and Mary Frances Jones are residents of Columbia, Missouri. They are shareholders at all relevant times of the Oakmark Equity and Income Fund and the Oakmark Global Fund.

20. Plaintiff Arline Winnerman is a resident of St. Petersburg, Florida. She is a shareholder at all relevant times of the Oakmark Fund.

21. Each of the Funds is a separate operating series of the Harris Associates Investment Trust, a Massachusetts business trust that is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 as an open-end management investment company.

22. Defendant Harris Associates LP ("Harris") is a Delaware limited partnership and is registered as an investment adviser under the Investment Advisers Act of 1940. Harris is the investment advisor to each of the Funds. Harris also serves as the investment advisor to individuals and other institutions, including trusts, retirement plans, endowments and foundations, and manages a number of private partnerships.

IV. GENERAL ALLEGATIONS

23. The test for determining whether compensation paid to Defendant violates § 36(b) is "essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances." *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982). In order to violate § 36(b), "the advisor-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Id.*

24. In applying this test, all pertinent facts must be weighed in determining whether a fee or other compensation violates § 36(b). The *Gartenberg* court specifically identified six factors (a portion of "all pertinent facts") to be considered in determining whether a fee is so disproportionately large that it bears no reasonable relationship to the services rendered. These factors include: (1) the nature and quality of the services rendered; (2) the profitability of the funds to the advisor/manager; (3) economies of scale; (4) comparative fee structures; (5) fallout benefits (i.e. indirect profits to the advisor/manager resulting from the existence of the funds; and (6) the care and

conscientiousness of the directors. A review of these factors, and the facts in this case, demonstrates that the fees charged by Defendant to the Funds violate § 36(b).

(1) The Nature and Quality of the Services Provided to the Funds

25. The nature of the investment advisory services provided to the Funds is straightforward: Defendant buys and sells, at its discretion, stocks, bonds, and other securities for the Funds. This is precisely the same service provided to Defendant's institutional and other clients (albeit at a dramatically lower cost). On information and belief, the materials provided by Defendant to the directors of the Funds establish that the nature of these services has remained unchanged despite dramatic growth in the assets of the Funds and advisory revenues.

26. Despite the fact that the Funds receive identical investment advisory services as Defendant's institutional and other clients, on information and belief Plaintiffs pay Defendant dramatically higher fees because these fees are not negotiated at arm's length as they are with the institutional and other clients. This disparity in fees evinces Defendant's willingness and determination to prefer their own financial interests to the interests of the Funds and the shareholders of the Funds.

27. On information and belief, Defendant repeatedly puts its own financial interests ahead of the interests of the Funds and the shareholders of the Funds by participating in arrangements and schemes that benefit Defendant at the expense of the Funds and their shareholders. The cost of this conflict of interest, which does not exist in the case of the arm's-length relationships with institutional clients,

is manifest not only in higher fees, but in other losses and expenses borne by the Funds and the shareholders of the Funds. These losses and expenses directly impact the quality of the investment advisory services Defendant provides to the Funds.

(2) The Profitability of the Fund to the Adviser/ Manager

28. "[T]he 'profitability of the fund to the adviser' [must] be studied in order that the price paid by the fund to its adviser be equivalent to 'the product of arm's-length bargaining.'" *See* John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 610, 661 (2001) (the "Freeman & Brown Study") (citing *Gartenberg*) [Ex. 1]. The profitability of a fund to an adviser-manager is a function of revenues minus the costs of providing services. However, upon information and belief, Defendant's reporting of its revenues and costs is intended to, and does, obfuscate Defendant's true profitability. For instance, upon information and belief, Defendant employs inaccurate accounting practices in its financial reporting, including arbitrary and unreasonable cost allocations.

29. Defendant's true profitability can be determined on either an incremental basis or a full-cost basis. Defendant's incremental cost of providing advisory services to Plaintiffs is nominal while the additional fees received by Defendant are hugely disproportionate given that the nature, quality, and level of the services remain the same. On information and belief, a review of Defendant's full costs of providing advisory services will also demonstrate the enormous profitability to Defendant of managing the Funds.

(3) Economies of Scale

30. The existence of economies of scale in the mutual fund industry has been recently confirmed by both the SEC and the Governmental Accounting Office (the "GAO"). Both conducted in-depth studies of mutual fund fees in 2000, and both concluded that economies of scale exist in the provision of advisory services. *See* SEC Division of Investment Management: Report on Mutual Fund Fees and Expenses (Dec. 2000) ("SEC Report"), at 30-31 [Ex. 2]; GAO, Report on Mutual Fund Fees to the Chairman, Subcommittee on Finance and Hazardous Materials; and the Ranking Member, Committee on Commerce, House of Representatives (June 2000) ("GAO Report"), at 9 [Ex. 3].

31. In addition, the most significant academic research undertaken since the Wharton School study in the 1960s establishes the existence of economies of scale that are not being passed along to mutual fund shareholders in violation of Defendant's duty to do so under § 36(b). *See* Freeman & Brown Study [Ex. 1]. As the Freeman & Brown Study noted: "The existence of economies of scale has been admitted in SEC filings made by fund managers and is implicit in the industry's frequent use of fee rates that decrease as assets under management increase. Fund industry investment managers are prone to cite economies of scale as justification for business combinations." *Id.* at 620 [Ex. 1].

32. These economies of scale exist not only fund by fund but also exist with respect to an entire fund complex and even with respect to an investment advisor's entire scope of operations, including services provided to institutional and other clients. *See* Freeman & Brown Study at 621 n.62 (quoting

Victoria E. Schonfeld & Thomas M.J. Kerwin, Organization of a Mutual Fund, 49 Bus. Law 107 (1993)) [Ex. 1].

33. The clearest example of economics of scale occurs when total assets under management increase due purely to market forces (without the institution of new advisory relationships or new asset gathering). In such instances, as the GAO confirms, it is possible for the advisor to service the additional assets with zero additional costs. *See* GAO Report at 9 (noting that growth from portfolio appreciation is unaccompanied by costs) [Ex. 3]. In other words, an investment advisor can advise a fund that doubles in size purely because of market forces with no increased costs because the services are unchanged. *See* GAO Report at 9 [Ex. 3]; Freeman & Brown Study at 619 n.43, 621 (noting that investment advisors have benefited by garnering "increased fees from the general increase in market prices with no commensurate efforts on their part" and also noting that as much as 64% of mutual fund asset growth has come from appreciation of portfolio securities, which, unlike growth from share sales to new investors, is costless) [Ex. 1].

34. From 1993 through 2003, the assets under management in the Oakmark Complex grew from $295.3 million to nearly $11.7 billion. However, this phenomenal growth in mutual fund assets not only produced no economies of scale, but fees actually increased faster than the growth in assets. Fees went from $2.45 million (or 0.83% of assets) in 1993 to $107.3 million (or 0.91% of assets) in 2003.

35. The economies of scale enjoyed by Defendant with respect to the Funds have not been shared with Plaintiffs as required by § 36(b). As a result, the fees

paid to Defendant for advisory services provided to the Funds are grossly disproportionate to those services, are excessive, and violate § 36(b).

(4) Comparative Fee Structures

36. The fees advisors receive from mutual funds for investment advisory services are directly comparable to, though much higher than, the fees advisors receive from other clients for the identical services. As the Freeman & Brown Study noted: "None of the leading advisory fee cases involved equity funds, and hence, none of the courts were confronted directly with the strong analogies that can be drawn between equity advisory services in the fund industry as compared to the pension field where prices are notably lower." Freeman & Brown Study at 653 [Ex. 1]. While a "manager may encounter different levels of fixed and variable research costs depending on the type of the portfolio, . . . the fundamental management process is essentially the same for large and small portfolios, as well as for pension funds and mutual funds. The portfolio owner's identity (pension fund versus mutual fund) should not logically provide a reason for portfolio management costs being higher or lower." Freeman & Brown Study at 627-28 [Ex. 1]. Indeed, "a mutual fund, as an entity, actually is an institutional investor. When it comes to fee discrepancies, the difference between funds and other institutional investors does not turn on 'institutional status,' it turns on self-dealing and conflict of interest." Freeman & Brown Study at 629 n.93 [Ex. 1]. Accordingly, the "'apples-to-apples' fee comparisons between equity pension managers and equity fund managers can be most difficult and embarrassing for those selling advice to mutual funds." Freeman & Brown Study at 671-72 [Ex. 1].

37. More recently, New York's Attorney General surveyed two fund complexes and confirmed the existence of massive over-charging of fund advisory fees. Specifically, Mr. Spitzer testified before a Senate Subcommittee on January 27, 2004, as follows:

> Putnam's mutual fund investors were charged 40 percent more for advisory services than Putnam's institutional investors. In dollar terms, what this fee disparity means is that in 2002 Putnam mutual fund investors paid $290 million more in advisory fees than they would have paid had they been charged the rate given to Putnam's institutional clients, and these are for identical services.
>
> There was a similar disparity in the advisory fees charged by Alliance. Once again, mutual fund investors were charged significantly higher advisory fees than institutional investors. Specifically, Alliance's mutual fund investors paid advisory fees that were twice those paid by institutional investors. In dollar terms, this means that Alliance investors paid more than $200 million more in advisory fees than they would have paid had they been charged the rate given to Alliance's institutional clients.

38. On information and belief, the shareholders of the Funds at issue here are plagued by the same discriminatory over-charging. Indeed, a number of relevant comparative fee structures clearly establish that Defendant is charging advisory fees to the Funds that are disproportionate to the value of the services rendered. For example, upon information and belief:

a. Harris serves as the subadvisor to the CDC Nvest Growth and Income Fund. For its services, Harris receives a fee equal to 45 basis points (.45%) of the first $250 Million in assets, 40 basis points (.40%) of the next $250 Million in assets, and 35 basis points (.35%) of assets over $500 Million (the "Nvest G&I Fee Schedule"). By way of contrast, for its services to the Oakmark Equity and Income Fund, Harris receives a fee equal to 75 basis points (.75%) of the first $5 Billion in assets, 70 basis points (.70%) of the next $2.5 Billion in assets, 675 basis points (.675%) of the next $2.5 Billion in assets, and 65 basis points (.65%) of assets over $10 Billion. As of June 2004, the Oakmark Equity and Income Fund had over $7.727 Billion in assets. If the Oakmark Equity and Income Fund were to have average assets of this amount throughout 2004, it would pay a blended fee of 73.2 basis points (.732%). However, if the Oakmark Equity and Income Fund benefited from the Nvest G&I Fee Schedule, the Oakmark Equity and Income Fund would pay a blended fee of only 35.5 basis points (.355%). Under this fee schedule, the Oakmark Equity and Income Fund would pay less than half of what it will pay under its current schedule, which would save the shareholders of the Oakmark Equity and Income Fund over $29 million in fees this year.

b. Harris serves as the subadvisor to the MassMutual Focused Value Fund (a mid-cap fund). For its services, Harris receives a fee equal to 50 basis points (.50%) of the first $100 Million in assets, 45 basis points (.45%) of the next $400 Million in assets, and 40 basis points

(.40%) of assets over $500 Million (the "MassMutual Focused Value Fee Schedule"). By way of contrast, for its services to the Oakmark Select Fund (also a mid-cap fund), Harris receives a fee equal to 100 basis points (1.00%) of the first $1 Billion in assets, 95 basis points (.95%) of the next $500 Million in assets, 90 basis points (.90%) of the next $500 Million in assets, 85 basis points (.85%) of the next $500 Million in assets, 80 basis points (.80%) of the next $2.5 Billion in assets, and 75 basis points (.75%) of assets over $5 Billion. As of June 2004, the Oakmark Select Fund had over $5.623 Billion in assets. If the Oakmark Select Fund were to have average assets of this amount throughout 2004, it would pay a blended fee of 85.7 basis points (.857%). However, if the Oakmark Select Fund benefited from the MassMutual Focused Value Fee Schedule, the Oakmark Select Fund would pay a blended fee of only 40.5 basis points (.405%). Under this fee schedule, the Oakmark Select Fund would pay less than half of what it will pay under its current schedule, which would save the shareholders of the Oakmark Select Fund over $25 million in fees this year.

c. Harris serves as the subadvisor to the MassMutual Overseas Fund. For its services, Harris receives a fee equal to 65 basis points (.65%) of the first $50 Million in assets, 60 basis points (.60%) of the next $50 Million in assets, and 50 basis points (.50%) of assets over $100 Million (the "MassMutual Overseas Fee Schedule"). By way of contrast, for its services to the Oakmark International Fund, Harris receives a fee equal to 100 basis points (1.00%) of the first

$2 Billion in assets, 95 basis points (.95%) of the next $1 Billion in assets, and 85 basis points (.85%) of assets over $3 Billion. As of June 2004, the Oakmark International Fund had over $4.231 Billion in assets. If the Oakmark International Fund were to have average assets of this amount throughout 2004, it would pay a blended fee of 94.5 basis points (.945%). However, if the Oakmark International Fund benefited from the MassMutual Overseas Fee Schedule, the Oakmark International Fund would pay a blended fee of only 50.3 basis points (.503%). Under this fee schedule, the Oakmark International Fund would pay slightly more than half of what it will pay under its current schedule, which would save the shareholders of the Oakmark International Fund over $18 million in fees this year.

(5) Fallout Benefits

39. Defendant indirectly profits because of the existence of the Funds through fallout benefits. Obvious, but difficult to quantify fallout benefits include the attraction of new customers, cross selling related funds to current customers, and other benefits associated generally with the development of goodwill and the growth in assets of the Funds.

40. Other, easier to quantify, benefits include "soft dollars" payable from broker-dealers. Essentially, "soft dollars" are credits furnished to Defendant from broker-dealers and other securities-industry firms in exchange for routing the Funds' securities transaction orders and other business to paying firms. These soft-dollar credits should be used to purchase research and other goods or services that benefit the shareholders of the Funds. On information and

belief, however, the soft-dollar arrangements benefit Defendant and result in increased costs to the shareholders of the Funds with little to no corresponding benefits to the shareholders of the Funds. On information and belief, the soft dollar arrangements are concealed from the shareholders of the Funds in breach of Defendant's fiduciary duty.

41. On information and belief, Defendant also receives "kickbacks," either directly or indirectly, as transfer agency and custodian fees grow due to increases in the assets of the Funds and the number of shareholders.

42. On information and belief, Defendant receives further fallout benefits from securities lending arrangements. Essentially, Defendant loans out the securities of the Funds and receives compensation as the lending agent of the Funds.

43. A highly profitable fallout benefit to Defendant is the ability to sell investment advisory services paid for by the Funds at virtually no additional cost. Much like computer software, once the investment research and resulting recommendations are paid for, that research and those recommendations may be sold to other clients at virtually no cost whatsoever to Defendant. Without payment by Plaintiffs and other shareholders of the Funds of millions of dollars in advisory fees, Defendant would have to pay to conduct that research independently in order to provide investment advisory services to other clients, including institutional clients. This is a natural byproduct of the extraordinary economies of scale inherent in the investment advisory business. However, although Plaintiffs and other shareholders of the Funds pay all of the costs associated with the investment advisory services, Defendant resells these

services to third parties without compensating shareholders through reduced fees or in any other way.

44. On information and belief, Defendant does not provide sufficient information regarding the existence and extent of these and other fallout benefits to the shareholders of the Funds or to the Funds' directors. The directors are thus unable to quantify or even meaningfully consider the benefits. Plaintiffs and other shareholders of the Funds have paid for these benefits and are entitled to compensation in the form of reduced advisory fees.

(6) The Independence and Conscientiousness of the Directors

45. At least 40% of the Funds' directors must be "disinterested" as defined in § 10 of the ICA. As the GAO Report noted, the structure of most mutual funds embodies a potential conflict of interest between the fund's shareholders and its adviser. This conflict arises because the fees paid by the shareholders represent revenue to the adviser. The United States Supreme Court has stated that the disinterested-director requirement is "the cornerstone of the ICA's efforts to control" this conflict of interest. *Burks v. Lasker*, 441 U.S. 471 (1979).

46. The disinterested directors are supposed to serve as "watchdogs" for the shareholders of the Funds. As such, the disinterested directors have primary responsibility for, among many other things, negotiating and approving all contracts and agreements with Defendant and reviewing the reasonableness of the advisory fees received by Defendant. Accordingly, as noted by the GAO, the directors are expected to review, among other things, the advisor's costs, whether fees have been reduced when the Funds' assets have grown, and the fees charged

for similar services. *See* GAO Report at 14 [Ex. 3]. These responsibilities are intensive, requiring the directors to rely on information provided by Defendant. Defendant, in turn, has a fiduciary duty to provide all information reasonably necessary for the directors to perform their obligations. *See* 15 U.S.C. § 80a-15(c).

47. The ICA contains a presumption that the disinterested directors are in fact disinterested. However, the lack of conscientiousness of even disinterested directors in reviewing the fees paid by the Funds, the lack of adequate information provided to the directors in connection with their approvals of the advisory agreements, and the control of management over the directors in reviewing the fees paid by the Funds are not presumed but, rather, are important factors recognized in the *Gartenberg* line of cases in determining whether Defendant has breached its fiduciary duties. In addition, the SEC has specifically recognized that even disinterested directors may not be independent but, rather, may be subject to domination or undue influence by a fund's investment adviser.

48. Two noteworthy industry insiders have commented on the general failure of mutual fund boards to fulfill their responsibilities under the ICA. Jack Bogle, founder of the Vanguard Group, made the following comment:

> Well, fund directors are, or at least to a very major extent, sort of a bad joke. They've watched industry fees go up year after year, they've added 12b-1 fees. I think they've forgotten, maybe they've never been told, that the law, the Investment Company Act, says they're required

> to put the interest of the fund shareholders ahead of the interest of the fund adviser. It's simply impossible for me to see how they could have ever measured up to that mandate, or are measuring up to it.

Warren Buffet, famous investor and chairman of Berkshire Hathaway, Inc., made the following comment, which was recently quoted by a United States District Court:

> I think independent directors have been anything but independent. The Investment Company Act, in 1940, made these provisions for independent directors on the theory that they would be the watchdogs for all these people pooling their money. The behavior of independent directors in aggregate since 1940 has been to rubber stamp every deal that's come along from management – whether management was good, bad, or indifferent. Not negotiate for fee reductions and so on. A long time ago, an attorney said that in selecting directors, the management companies were looking for Cocker Spaniels and not Dobermans. I'd say they found a lot of Cocker Spaniels out there. *Strougo v. BEA Assoc.*, 188 F. Supp.2d 373, 383 (S.D.N.Y. 2002) (citation omitted).

Mr. Buffet also stated, in a letter to shareholders in the 2002 Berkshire Hathaway, Inc. annual report:

> [A] monkey will type out a Shakespeare play before an "independent" mutual-fund director will suggest that his fund look at other managers, even if the incumbent manager has persistently delivered sub-

> standard performance. When they are handling their own money, of course, directors will look to alternative advisors – but it never enters their minds to do so when they are acting as fiduciaries for others. . . . Investment company directors have failed as well in negotiating management fees . . . . If you or I were empowered, I can assure you that we could easily negotiate materially lower management fees with the incumbent managers of most mutual funds. And, believe me, if directors were promised a portion of any fee savings they realized, the skies would be filled with falling fees. Under the current system, though, reductions mean nothing to "independent" directors while meaning everything to managers. So guess who wins? . . . [I]n stepping up to [their] all-important responsibilities, tens of thousands of "independent" directors, over more than six decades, have failed miserably. (They've succeeded, however, in taking care of themselves; their fees from serving on multiple boards of a single "family" of funds often run well into six figures.) 2002 Berkshire Hathaway, Inc. Annual Report to Shareholders, p. 17 – 18.

49. As part of their scheme to receive excessive fees, Defendant did not keep the directors fully informed regarding all material facts and aspects of its fees and other compensation, and the directors failed to insist upon adequate information. For example:

a. On information and belief, Defendant provided virtually no information to the directors regarding the advisory fees charged to pension and other institutional clients or to other mutual funds being advised or sub-advised by Defendant.

b. On information and belief, Defendant provided virtually no information to the directors regarding the economies of scale enjoyed or fall-out benefits received by Defendant.

c. On information and belief, the profitability data given to the board of directors provide no explanation as to how the board should evaluate economies of scale.

d. On information and belief, the directors rarely, if ever, question any information or recommendations provided by Defendant.

50. The foregoing assures that the directors do not understand Defendant's true cost structure and, in particular, the economies of scale enjoyed by Defendant in providing investment advisory services to the Funds and its institutional and other clients.

51. On information and belief, the disinterested directors of the Funds have not received the benefit of any measures to enhance their ability to act independently, which has caused the directors to be dependent on Defendant and has allowed Defendant to dominate and unduly influence the directors. In addition, the directors' failure to insist on adequate information evinces a lack of care and conscientiousness on their part.

COUNT I
ICA § 36(b)
BREACH OF FIDUCIARY DUTY
(Excessive Investment Advisory Fees)

52. Plaintiffs repeat and re-allege each allegation contained in the foregoing paragraphs of this Complaint as if fully set forth herein.

53. The fees charged by Defendant for providing advisory services to the Funds are and continue to be disproportionate to the services rendered and are not within the range of what would have been negotiated at arm's length in light of all the surrounding circumstances, including the advisory fees that Defendant charges its other clients.

54. In charging and receiving excessive or inappropriate compensation, and in failing to put the interests of Plaintiffs and the other shareholders of the Funds ahead of its own interests, Defendant has breached and continues to breach its statutory fiduciary duty to Plaintiffs in violation of ICA § 36(b).

55. Plaintiffs seek, pursuant to § 36(b)(3) of the ICA, the "actual damages resulting from the breach of fiduciary duty" by Defendant, up to and including, "the amount of compensation or payments received from" the Funds.

COUNT II
ICA § 36(b)
BREACH OF FIDUCIARY DUTY
(Excess Profits from Economies of Scale)

56. Plaintiffs repeat and re-allege each allegation contained in the foregoing paragraphs of this Complaint as if fully set forth herein.

57. Defendant has received and continues to receive excess profits attributable to extraordinary economies of scale.

58. By retaining excess profits derived from economies of scale, Defendant has breached and continues to breach its statutory fiduciary duty to Plaintiffs in violation of ICA § 36(b).

59. Plaintiffs seek, pursuant to § 36(b)(3) of the ICA, the "actual damages resulting from the breach of fiduciary duty" by Defendant, up to and including, the "amount of compensation or payments received from" the Funds.

WHEREFORE, Plaintiffs demand judgment as follows:

a. An order declaring that Defendant has violated and continues to violate § 36(b) of the ICA and that any advisory agreements entered into are void ab initio;

b. An order preliminarily and permanently enjoining Defendant from further violations of the ICA;

c. An order awarding damages against Defendant including all fees paid to them by Plaintiffs and the Funds for all periods not precluded by any applicable statute of limitation through the trial of this case, together with interest, costs, disbursements, attorneys' fees, and such other items as may be allowed to the maximum extent permitted by law; and

d. Such other and further relief as may be proper and just.

By: /s/ NINA H. FIELDS

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June 10, 2005

[Exhibits Omitted]

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed May 16, 2005]

DEFENDANT'S ANSWER TO PLAINTIFFS' AMENDED COMPLAINT

Defendant, Harris Associates L.P. ("Harris"), answers Plaintiffs' Complaint as follows:

I. JURISDICTION AND VENUE

1. Defendant admits that Plaintiffs purport to bring this cause of action as a derivative action on behalf of various mutual funds, pursuant to § 36(b) of the Investment Company Act of 1940 ("ICA"), as amended 15 U.S.C. §§ 80a-35(b). Defendant denies that Plaintiffs have any claim under this section.

2. Defendant admits the allegations contained in Paragraph 2 of the Complaint.

3. Defendant admits that venue is proper in the United States District Court for the Northern District of Illinois and states that the balance of Para-

graph 3 of the Complaint states legal conclusions for which no answer is required. Defendant reserves all rights to challenge Plaintiffs' statements of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a further response is required, defendant denies the remaining allegations contained in Paragraph 3 of the Complaint.

4. Paragraph 4 of the Complaint contains legal conclusions for which no answer is required. Defendant reserves all rights to challenge Plaintiffs' statements of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required, defendant denies the allegations contained in Paragraph 4 of the Complaint.

II. BACKGROUND

5. Paragraph 5 of the Complaint contains legal conclusions for which no answer is required. Defendant reserves all rights to challenge Plaintiffs' statements of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. Defendant denies the allegations in Paragraph 5 to the extent they are factual, except, without conceding that Plaintiffs have standing, it admits that some of the Plaintiffs are or were shareholders, at certain points in time, in some of the funds, which are funds in the Oakmark family of mutual funds, for which Harris serves as investment adviser.

6. Defendant denies the allegations contained in the first sentence of Paragraph 6 of the Complaint, as neither Plaintiffs nor defendant pay the fees at issue in this action. Defendant denies the allegations in the second sentence of Paragraph 6 of the Com-

plaint. Defendant admits that the Funds pay administrative fees for certain administrative services provided to the Funds by Defendant's affiliates or other third parties.

7. Defendant denies the allegations contained in Paragraph 7 of the Complaint.

8. Defendant denies the allegations contained in Paragraph 8 of the Complaint.

9. Paragraph 9 of the Complaint contains legal conclusions for which no answer is required. Defendant reserves all rights to challenge Plaintiffs' statements of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required, defendant denies the allegations contained in Paragraph 9 of the Complaint, except that defendant admits that Congress enacted the ICA in 1940 and that § 36(b) was added to the ICA in 1970.

10. Defendant admits that a portion of Section 36(b) is quoted in Paragraph 10 of the Complaint.

11. Defendant denies the allegations contained in Paragraph 11 of the Complaint.

12. Defendant denies the allegations contained in Paragraph 12 of the Complaint.

13. Defendant denies the allegations contained in Paragraph 13 of the Complaint.

14. Paragraph 14 of the Complaint contains legal conclusions for which no answer is required. Defendant reserves all rights to challenge Plaintiffs' statements of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required, defendant denies the allega-

tions therein to the extent they are factual, except defendant admits that a majority of the fund's board is comprised of directors who are not interested persons of the funds and that fund's board has approved the fees paid to defendant in a manner meeting all legal requirements.

15. Defendant denies the allegations in the first sentence of Paragraph 15 of the Complaint. Defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in the remainder of Paragraph 15 of the Complaint.

16. Defendant admits that Plaintiffs seek the relief set forth in Paragraph 16 of the Complaint but denies that Plaintiffs are entitled to such relief. To the extent that a further response is required, defendant denies any remaining factual allegations contained in Paragraph 16 of the Complaint.

17. Paragraph 17 of the Complaint contains legal conclusions for which no response is required. Defendant reserves all rights to challenge Plaintiffs' statement of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required, defendant denies the allegations contained in Paragraph 17 of the Complaint.

18. Defendant admits that Plaintiffs do not seek the relief described in Paragraph 18 of the Complaint.

III. PARTIES

19. Without conceding that Plaintiffs have standing, defendant admits that Plaintiffs Jerry N. Jones and Mary Frances Jones were at certain points in time or are shareholders in the Oakmark Global Fund. Defendant lacks knowledge or information

sufficient to form a belief as to the truth of the remaining allegations contained in Paragraph 19 of the Complaint.

20. Defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph 20 of the Complaint.

21. Defendant admits the allegations contained in Paragraph 21 of the Complaint.

22. Defendant admits the allegations contained in Paragraph 22 of the Complaint.

IV. GENERAL ALLEGATIONS

23. Paragraph 23 of the Complaint contains legal conclusions for which no response is required. Defendant reserves all rights to challenge Plaintiffs' statement of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required, defendant denies the allegations contained in Paragraph 23 of the Complaint.

24. Paragraph 24 of the Complaint contains legal conclusions for which no response is required. Defendant reserves all rights to challenge Plaintiffs' statement of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required, defendant denies the allegations contained in Paragraph 24 of the Complaint.

25. Defendant denies the allegations contained in Paragraph 25 of the Complaint.

26. Defendant denies the allegations contained in Paragraph 26 of the Complaint.

27. Defendant denies the allegations contained in Paragraph 27 of the Complaint.

28. The first sentence of Paragraph 28 of the Complaint contains legal conclusions for which no response is required. Defendant reserves all rights to challenge Plaintiffs' statement of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. The allegations contained in the second sentence of Paragraph 28 of the Complaint do not purport to relate to defendant and thus no response is required; defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations. Defendant denies the remaining allegations contained in Paragraph 28 of the Complaint.

29. Defendant denies the allegations contained in Paragraph 29 of the Complaint.

30. The allegations in Paragraph 30 of the Complaint do not purport to relate to the defendant and thus defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph 30 of the Complaint.

31. The allegations in Paragraph 31 of the Complaint do not purport to relate to the defendant and thus defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph 31 of the Complaint.

32. The allegations in Paragraph 32 of the Complaint do not purport to relate to the defendant and thus defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph 32 of the Complaint.

33. The allegations in Paragraph 33 of the Complaint do not purport to relate to the defendant and thus defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph 33 of the Complaint.

34. Defendant denies the allegations contained in Paragraph 34 of the Complaint.

35. Defendant denies the allegations contained in Paragraph 35 of the Complaint.

36. The allegations in Paragraph 36 of the Complaint do not purport to relate to the defendant and thus defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph 36 of the Complaint.

37. The allegations in Paragraph 37 of the Complaint do not purport to relate to the defendant and thus defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph 37 of the Complaint.

38. Defendant denies the allegations contained in Paragraph 38 of the Complaint except:

a. Defendant admits that it serves as the subadvisor to the fund formerly known as the CDC Nvest Growth and Income Fund[1] for which, during the relevant time period, it received a fee equal to 45 basis points of the first $250 million in assets, 40 basis points of the next $250 million in assets, and 35 basis points of assets over $500 million. Defendant admits that it serves as investment adviser to the Oakmark Equity and Income Fund for which, during the relevant time period, it received a fee equal to 75 basis points of the first $5 billion in assets, 70 basis points of the next $2.5 billion in assets, 67.5 basis points of

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[1] In August 2004, the fund was re-named CDC Harris Associates Large Cap Value Fund.

the next $2.5 billion in assets and 65 basis points of assets over $10 billion.

b. Defendant admits that it serves as the subadvisor to the MassMutual Focused Value Fund for which, during the relevant time period, it received a fee equal to 50 basis points of the first $100 million in assets, 45 basis points of the next $400 million in assets, and 40 basis points of assets over $500 million. Defendant admits that it serves as investment adviser to the Oakmark Select Fund for which, during the relevant time period, it received a fee equal to 100 basis points of the first $1 billion in assets, 95 basis points of the next $500 million in assets, 90 basis points of the next $500 million in assets, 85 basis points of the next $500 million in assets, 80 basis points of the next $2.5 billion in assets, and 75 basis points of assets over $5 billion.

c. Defendant admits that it serves as the subadvisor to the MassMutual Overseas Fund for which, during the relevant time period, it received a fee equal to 65 basis points of the first $50 million in assets, 60 basis points for the next $50 million in assets and 50 basis points of assets over $100 million. Defendant admits that it serves as the investment advisor to the Oakmark International Fund for which, during the relevant time period, it received a fee equal to 100 basis points of the first $2 billion in assets, 95 basis points of the

next $1 billion in assets, and 85 basis points of assets over $3 billion.

39. Defendant denies the allegations contained in Paragraph 39 of the Complaint.

40. Defendant denies the allegations contained in Paragraph 40 of the Complaint.

41. Defendant denies the allegations contained in Paragraph 41 of the Complaint.

42. Defendant denies the allegations contained in Paragraph 42 of the Complaint.

43. Defendant denies the allegations contained in Paragraph 43 of the Complaint.

44. Defendant denies the allegations contained in Paragraph 44 of the Complaint.

45. Paragraph 45 of the Complaint contains legal conclusions for which no response is required. Defendant reserves all rights to challenge Plaintiffs' statement of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required, defendant denies the allegations contained in Paragraph 45 of the Complaint.

46. Except for the last sentence, the allegations in Paragraph 46 do not purport to relate to the defendant, and thus defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in the first four sentences of Paragraph 46 of the Complaint. The fifth sentence of Paragraph 46 contains a legal conclusion for which no response is required. Defendant reserves all rights to challenge Plaintiffs' statement of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required,

defendant denies the allegations contained in Paragraph 46 of the Complaint.

47. Paragraph 47 of the Complaint contains legal conclusions for which no response is required. Defendant reserves all rights to challenge Plaintiffs' statement of legal conclusions and denies that Plaintiffs have completely or accurately characterized the legal principles applicable to this case. To the extent that a response is required, defendant denies the allegations contained in Paragraph 47 of the Complaint.

48. The allegations contained in Paragraph 48 of the Complaint do not purport to relate to the defendant, and thus defendant lacks knowledge or information sufficient to form a belief as to the truth of the allegations contained in Paragraph 48 of the Complaint.

49. Defendant denies the allegations contained in Paragraph 49 of the Complaint.

50. Defendant denies the allegations contained in Paragraph 50 of the Complaint.

51. Defendant denies the allegations contained in Paragraph 51 of the Complaint.

COUNT I

52. Defendant incorporates by reference, as if fully set forth herein, its responses to Paragraphs 1-51 of the Complaint.

53. Defendant denies the allegations contained in Paragraph 53 of the Complaint.

54. Defendant denies the allegations contained in Paragraph 54 of the Complaint.

55. Defendant admits that Plaintiffs seek the relief set forth in Paragraph 55 of the Complaint but denies that Plaintiffs are entitled to such relief.

COUNT II

56. Defendant incorporates by reference, as if fully set forth herein, its responses to Paragraphs 1-55 of the Complaint.

57. Defendant denies the allegations contained in Paragraph 57 of the Complaint.

58. Defendant denies the allegations contained in Paragraph 58 of the Complaint.

59. Defendant admits that Plaintiffs seek the relief set forth in Paragraph 59 of the Complaint but denies that Plaintiffs are entitled to such relief.

60. Defendant denies each and every allegation contained in the "WHEREFORE" clause of the Complaint.

61. Defendant denies each and every allegation not specifically admitted herein.

AFFIRMATIVE DEFENSES

Without assuming any burden of proof that it would not otherwise bear under applicable law and without prejudice to defendant's right to assert any other defenses that may emerge, defendant asserts the following defenses to the Complaint:

1. The Complaint fails to state a claim upon which relief may be granted.

2. Plaintiffs' claims are barred, in whole or part, because Plaintiffs lack standing to assert the claims.

3. Plaintiffs' claims are barred, in whole or part, by the applicable statute of limitations.

4. Plaintiffs' claims are barred, in whole or part, by the doctrines of laches, waiver, estoppel, unclean hands, ratification, disclosure and/or consent, and other related doctrines and principles.

5. Defendant hereby gives notice that it intends to rely upon such other and further defenses as may become available or apparent during pre-trial proceedings in this case and hereby reserves all rights to assert such defenses.

WHEREFORE, defendant respectfully prays that this Court dismiss all claims in the Complaint with prejudice as may otherwise be appropriate and that the Court grant it other relief as it deems just and proper.

Dated: May 16, 2005.

Respectfully submitted,

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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed Sept. 12, 2006]

PLAINTIFFS' STATEMENT OF UNDISPUTED MATERIAL FACTS PURSUANT TO LOCAL RULE 56.1

A. PARTIES

1. The named Plaintiffs are Jerry N. Jones, Mary Frances Jones, and Arline Winerman. *See* Am. Compl. [attached as Exhibit A-1] at ¶¶ 19-20. The Defendant is Harris Associates L.P. *See* Ex. A-1 at ¶ 22.

2. Jerry N. Jones and Mary Frances Jones are residents of Columbia, Missouri. *See* Ex. A-1 at ¶ 19. At the time the Complaint was filed, Mr. and Mrs. Jones jointly owned shares in the Oakmark Equity and Income Fund and the Oakmark Global Fund. They have owned shares in the Oakmark Equity and Income Fund since December 22, 2003, and have held those shares throughout the relevant period.

See Transaction Confirmation, Dec. 23, 2003 (HA-JFJ-0001) [attached as Exhibit B-1]; Investor Services Account Statement of Jerry N. and Mary Frances Jones, Aug. 31, 2005 (HA-JFJ-0002 to -0003) [attached as Exhibit B-2]. They have owned shares in the Oakmark Global Fund since March 12, 2004, and have held those shares throughout the relevant period. *See* Oakmark Account Statements of Jerry N. and Mary Frances Jones, Dec. 31, 2004 and June 30, 2005 (HA-JFJ-0004; HA-JFJ-0010) [attached as Exhibits B-3 and B-4].

3. Arline Winerman is a resident of St. Petersburg, Florida. *See* Ex. A-1 at ¶ 20. At the time the Complaint was filed, Ms. Winerman owned shares in the Oakmark Fund. She has owned shares in the Oakmark Fund since December 10, 2003, and has held those shares throughout the relevant period. *See* Transaction Confirmation, Dec. 10, 2003 [attached as Exhibit B-5]; Fidelity Account Statement of Arline S. Winerman, July 31, 2005 [attached as Exhibit B-6].

4. The Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund (the "Funds") are separate operating series of the Harris Associates Investment Trust, a Massachusetts business trust that is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 ("ICA") as an open-end management investment company. *See* Ex. A-1 at ¶ 21; Def.'s Answer [attached as Exhibit A-2)] at ¶ 21; Statement of Additional Information, Oakmark Family of Funds ("SAI"), Jan. 29, 2003 (HA0006101) [attached as Exhibit C-3], at pp. 1-2; SAI, Jan. 31, 2004 (HA0006195) [attached as Exhibit C-4], at pp.

1-2; SAI, Jan. 28, 2005 [attached as Exhibit C-5], at pp. 1-2.

5. Harris Associates L.P. ("HALP") is a Delaware limited partnership that is registered as an investment adviser under the Investment Advisers Act of 1940. HALP is the investment adviser to each of the Funds. *See* Exs. A-1 and A-2 at ¶ 22; Ex. C-3 at pp. 19-21; Ex. C-4 at pp. 19-21; Ex. C-5 at pp. 17-20.

6. Harris Associates, Inc. ("HAI") is the general corporate partner of HALP (collectively with HAI, "Harris"). HAI manages HALP through a board of directors. *See* Ex. C-3 at p. 21; Ex. C-4 at p. 21; Ex. C-5 at p. 19.

7. Each of the Funds pays HALP a monthly investment advisory fee based on each Fund's net assets at the end of the preceding month. For the fiscal year ended September 30, 2003, HALP charged the Funds over $63 million in investment advisory fees, and for the fiscal year ended September 30, 2004, HALP charged the Funds over $109 million in investment advisory fees. *See* Ex. C-4 at p. 20; Ex. C-5 at p. 18. The investment advisory fees paid during these periods were approved by the Funds' Board of Trustees at meetings held October 16, 2002, and October 21, 2003. *See* Ex. C-3 at p. 20; Ex. C-4 at p. 20; *see also* Minutes of Meeting of Bd. of Trustees, Oct. 16, 2002 (HA9429) [attached as Exhibit D-2], at pp. 6-7; Minutes of Meeting of Bd. of Trustees, Oct. 21, 2003 (HA 2891) [attached as Exhibit D-4], at pp. 12-13.

B. JURISDICTION AND VENUE

8. This action is a derivative action brought by Plaintiffs on behalf of the Funds pursuant to § 36(b) of the Investment Company Act of 1940 ("ICA"), as

amended, 15 U.S.C. §§ 80a-35(b). *See* Exs. A-1 and A-2 at ¶ 1.

9. This Court has subject matter jurisdiction pursuant to 15 U.S.C. § 80a-43, 15 U.S.C. § 80a-35(b)(5), and 28 U.S.C. § 1331. *See* Exs. A-1 and A-2 at ¶ 2.

10. Venue is proper in this judicial district pursuant to 15 U.S.C. § 80a-43 and 28 U.S.C. § 1391(b). *See* Exs. A-1 and A-2 at ¶ 3. Defendant's principal place of business is Two North LaSalle Street, Suite 500, Chicago, Illinois 60602. *See* Def.'s Initial Disclosures, Oct. 27, 2004 [attached as Exhibit A-3], at p. 3. Accordingly, Defendant is an inhabitant of this district, transacts business in this district, resides in this district, and may be found in this district. In addition, a substantial part of the events or omissions that give rise to Plaintiffs' claims occurred in this district. Ex. A-1 at ¶ 3.

C. BOARD OF TRUSTEES

11. From January 1, 2001 to July 16, 2003, the Board of Trustees for the Funds was comprised of eight "disinterested" trustees and one "interested" trustee.[1] The disinterested trustees were: Victor Morgenstern (Chairman), Gary N. Wilner, Burton W. Ruder, Marv R. Rotter, Michael J. Friduss, Allan J. Reich, Thomas H. Hayden, and Christine M. Maki. The interested trustee was Peter S. Voss, President and CEO of Harris' parent company. *See* SAI, Jan.

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[1] For purposes of these Statements of Fact, Plaintiffs use the terms "disinterested" and "interested" to describe trustees as they were purported to be in Harris' public disclosures. As demonstrated in the Statements of Facts and Plaintiffs Memo of Law in Supp. of Mot. for Summ. J., these terms do not describe the actual disinterestedness or lack thereof that is the basis for the motion.

26, 2001 (HA0052492) [attached as Exhibit C-1], at pp. 18-19; SAI, Jan. 31, 2002 (HA0009880) [attached as Exhibit C-2], at pp. 21-22; Ex. C-3 at pp. 22-23. On July 16, 2003, John Raitt, President and CEO of Harris, was added as an interested trustee. *See* Minutes of Meeting of Bd. of Trustees, July 16, 2003 (HA0002862) [attached as Exhibit D-3], at pp. 20-21; *see also* Ex. C-4 at pp. 23-24. This composition remained in place until Victor Morgenstern resigned as a disinterested trustee effective January 1, 2005. *See* Minutes of Meeting of Governance Committee of the Board of Trustees, Dec. 1, 2004 (IT04386) [attached as Exhibit D-25], at p. 3.

12. The Board of Trustees is responsible for approving the investment advisory fees on an annual basis. During the period January 1, 2001 to January 1, 2005, the Board of Trustees had an Executive Committee, a Governance Committee, and a Management Contracts Committee. The Executive Committee generally has the authority to exercise the powers of the Board of Trustees during intervals between meetings. The principal functions of the Governance Committee was to make recommendations to the board regarding board committees and committee assignments, the composition of the board, candidates for election as non-interested trustees and compensation of non-interested trustees, and to oversee the process for evaluating the functioning of the board. The principal functions of the Management Contracts Committee was to review, and make recommendations to the board regarding, investment advisory agreements and any other agreements relating to the management or administration of the funds. *See* Ex. C-2 at p. 24; Ex. C-3 at p. 26; Ex. C-4 at pp. 27-28; Ex. C-5 at p.26; Minutes

of Meeting of Bd. of Trustees, Jan. 17, 2001 (HA0010794) [attached as Exhibit D-1], at pp. 6-7.

13. Morgenstern became an interested trustee of the Funds in 1991. *See* Ex. C-4 at p. 23. Prior to January 1, 2001, Morgenstern was a partner at HALP and Chairman of the board of directors of HAI. *See id.* Effective January 1, 2001, Morgenstern retired from the Harris and became a "disinterested" trustee of the Funds as well as Chairman of the Board. *See* Ex. D-1 at pp. 5-6. Morgenstern began receiving compensation as a disinterested trustee, as well as an additional $50,000 per year for serving as Chairman, and was appointed to the Executive Committee (as chair), Governance Committee, and Management Contract Committee as a disinterested trustee. *See id.* at pp. 5-7. On November 9, 2004, Morgenstern resigned his position as an independent trustee effective January 1, 2005. *See* Ex. D-25 at p. 3; Deposition of Victor Morgenstern, Sept. 23, 2005 [attached as Exhibit E-1], at pp. 87-88.

14. Wilner has been an independent trustee of the Funds since 1993 and became chairman sometime after Morgenstern's resignation. *See* Ex. C-4 at p. 24; Ex. C-5 at p. 23; Deposition of Gary Wilner, Sept. 13, 2005 [attached as Exhibit E-2], at pp. 19-20. He has been a member of the Executive and Governance Committees since 2001 and served as chairman of the Governance Committee in 2004. *See* Ex. D-1 at p. 7; Ex. C-4 at p. 28.

15. Ruder has been an independent trustee of the Funds since 1995. *See* Ex. C-4 at p. 24. He has been a member of the Governance and Management Contracts Committees since 2001 and served as Committee chairman from 2001 to 2003. *See* Ex. D-1 at p. 7; Ex. C-3 at p. 26.

16. Rotter has been an independent trustee of the Funds since 1996. *See* Ex. C-4 at p. 24. He has been a member of the Management Contracts Committee since 2001. *See* Ex. D-1 at p. 7.

17. Reich has been an independent trustee of the Funds since 1993. *See* Ex. C-4 at p. 24. He has been a member of the Governance Committee since 2001. *See* Ex. D-1 at p. 7.

18. Friduss has been an independent trustee of the Funds since 1995. *See* Ex. C-4 at p. 23. He was a member of the Management Contracts Committee from 2001 to 2004, serving as Committee chairman from 2001 to 2002, and became a member of the Governance Committee in 2004. *See* Ex. D-1 at p. 7; Ex. C-4 at p. 28.

19. Hayden has been an independent trustee of the Funds since 1995. *See* Ex. C-4 at p. 24. He has been a member of the Management Contracts Committee since 2001 and became Committee chairman in 2004. *See* Ex. D-1 at p. 7; Ex. C-4 at p. 28.

20. Maki has been an independent trustee of the Funds since 1996. *See* Ex. C-4 at p. 24. She was a member of the Governance Committee from 2001 to 2004 and became a member of the Executive Committee in 2004. *See* Ex. D-1 at p. 7; Ex. C-4 at pp. 27-28.

D. TRUSTEE CONFLICTS

1. Morgenstern's "C" Plan Compensation

21. After resigning from Harris on January 1, 2001, and becoming a trustee of the Funds, Morgenstern became entitled to receive deferred compensation from Harris pursuant to what is called the "C" Compensation Plan ("C Plan"). *See* Harris Associates L.P. "C" Compensation Plan, Oct. 1, 1995 [attached

as Exhibit G-1]; Harris Associates L.P. "C" Compensation Plan as Amended and Restated, July 1, 2003 [attached as Exhibit G-2]; Harris Associates L.P. Summary of C Plan Provisions (HA_N000000068) [attached as Exhibit G-3].

22. Morgenstern's C Plan payments were based on compensation he had previously received in connection with his ownership of "C units" in Harris. *See* Exhibit E-1 at p. 17. While the total amount of C Plan compensation was potentially fixed and was to be paid over six years, the actual payments could be reduced each year based on certain limits associated with HALP's revenues. *See* Ex. G-1 and G-2 at ¶¶ 2.01, 2.02, 6.2; Ex. G-3 at p.2; Ex. E-1 at pp. 16-19; Deposition of Kristi Rowsell, Nov. 28, 2005 [attached as Exhibit E-3], at pp. 88-90. The reductions could be made up in subsequent years if there were sufficient revenues, but any reductions not made up within four years after the expiration of the sixth year (for a total period of ten years) would be forfeited. *See* E-1 at pp. 16-19; Ex. E-3 at pp. 90-92. Consequently, payments to deferred payees under the C plan can be reduced, and ultimately forfeited, as a function of HALP's revenues, which revenues are derived in large measure from the investment advisory fees paid to HALP by the Funds (¶ 7, *supra*).

23. The targeted amount of Morgenstern's C Plan compensation was $632,125. *See* Ex. E-3 at 89:20 to 90:23; Lapsing Schedule of Deferred Payees (HA_N000000039) [attached as Exhibit G-4]. However, in 2001 (his first year of eligibility for deferred C Plan compensation) Morgenstern received only $585,316 because HALP's revenues in 2001 were not sufficient to entitle him to the entire $632,125. *See*

Ex. E-3 at pp. 90-92; Partner Compensation History (HA_N000000041) [attached as Exhibit G-5].

24. The amount of funds available for distributions from the C Plan included revenues from Harris Alternatives, which at one time was an operating unit within HALP that managed funds of hedge funds, but was spun off as a separate entity in 2003). *See* Ex. E-1 at pp. 20-22; Ex. E-3 at p. 26.

25. Other participants in the C Plan who received deferred payments while Morgenstern was a trustee for the Funds include Anita Nagler, Roxanne Martino, and Anita Rosenberg, all of whom left Harris in the spin off of Harris Alternatives, and Sherwin Zuckerman. *See* Exs. G-4 and G-5.

2. Personal and Business Relationships Between Morgenstern and the Other Trustees

26. Morgenstern, Wilner, and Ruder have been neighbors in Highland Park and have socialized for many years. They have children who are contemporaries. Morgenstern and Wilner are close friends and have vacationed together for 20 years. Morgenstern and Ruder often talk or meet weekly and have also vacationed together, including at property owned by Morgenstern and Wilner and a trip to Israel for Ruder's son's bar mitzvah about 11 years ago. *See* Ex. E-1 at pp. 64-65; Ex. E-2 at pp. 42, 57, 75-77; Deposition of Burton Ruder, Sept. 26, 2005 [attached as Exhibit E-4], at pp. 29-35.

27. Approximately 10 years ago, while Morgenstern was still a partner at Harris and Wilner was a trustee of the Funds, Morgenstern and Wilner formed a partnership called Bear East Partners. Bear East Partners invested in, among other things, Endologix and Tekelec, in which Morgenstern believed

current and former Harris partners may also have invested. Prior to substantially liquidating the partnership in 2005, it was worth approximately $200,000. *See* Ex. E-1 at pp. 33-38; Ex. E-2 at pp. 43-48. Bear East Partners' trades were sent through Harris. *See* Ex. E-2 at p. 46.

28. In addition to the entities detailed below (BioSante and Valor Equity Partners), Morgenstern and Wilner have invested together in real estate. While Morgenstern was still a partner at Harris and Wilner was a trustee of the Funds, they sold property they owned together (with a third person) to a then-partner of Morgenstern at Harris, Robert Sanborn. They originally bought the property for approximately $600,000 and sold it to Sandborn in February of 1999 for $2.25 million. They made "a very nice profit" according to Wilner. Morgenstern and Wilner have also owned vacation property together in Steamboat Springs, Colorado, for 16 or 17 years. This property is worth approximately $1 million. *See* Ex. E-1 at pp. 54-56; Ex. E-2 at pp. 49-50, 71.

29. Wilner is involved as a trustee or potential substitute trustee for one of Morgenstern's family trusts. *See* Ex. E-1 at pp. 69-71.

30. In addition to the entities detailed below (BioSante and Valor Equity Partners), Ruder has invested with Morgenstern in entity called Super Cerca, which Morgenstern introduced to Ruder. *See* Ex. E-4 at pp. 36, 38-39.

31. Morgenstern has also been friends with Friduss since 1960. They attended college together at Illinois Institute of Technology, and they now live near one another. Friduss' brother, Jarvis, was Morgenstern's personal accountant for several years. *See* Ex. E-1 at pp. 51-52, 63-64; Ex. E-2 at p. 79;

Deposition of Michael Friduss, Sept. 1, 2005 [attached as Exhibit E-5], at pp. 21-23.

32. In 1993 and 1995, Morgenstern recommended Wilner, Ruder, and Friduss as "disinterested" trustees of the Funds. They were selected as trustees by the partners at Harris. *See* Ex. E-1 at pp. 62-63, 67-68; Ex. E-2 at pp. 77, 79; Ex. E-4 at p. 29; Ex. E-5 p. 21.

3. Personal and Business Relationships Between Morgenstern and Other Harris Personnel

33. Sherwin Zuckerman is a close friend and former partner of Morgenstern at Harris. Zuckerman serves as a trustee of Morgenstern's family trusts. In addition to the entities detailed below (BioSante and Valor Equity Partners), Morgenstern and Zuckerman have numerous common investments, including Hesperus Partners, the Harris Glencoe Partnership, a series of the Walton Street Real Estate Fund, and Constable Partners. *See* Ex. E-1 at p. 57, 59, 68-69, 71, 74, 105-07, 115. Zuckerman retired from Harris a year after Morgenstern. *See id.* at p. 66.

34. After Morgenstern retired from Harris, he continued to serve as a trustee of a personal trust for Earl Rusnak, a partner at Harris. Rusnak retired from Harris approximately 3 years after Morgenstern retired. *See* Ex. E-1 at pp. 71-73.

35. Morgenstern is a trustee of the Illinois Institute of Technology along with two former partners of his at Harris, Anita Nagler and Ralph Wanger. *See* Ex. E-1 at p. 73.

36. Morgenstern invested in a number of investment vehicles and private equity funds in addition to those described above and those detailed below (BioSante and Valor Equity Partners) that may have

had investors who were current or former partners of Harris or current or former trustees of the Funds, but he did not know or could not recall. *See* Ex. E-1 at pp. 78-84, 98-101. For instance, Morgenstern recalled that he and Bob Levy (current Harris partner) invested together in Sonoma Lodge and that he and Peter Foreman (former Harris partner) invested together in Austin/Churchill Forge Properties and Northbrook Partners. *See id.* at pp. 75, 95-96, 116-117.

4. BioSante Pharmaceuticals, Inc.

37. Morgenstern was a director and substantial shareholder in a company called Biosante Pharmaceuticals beginning in the late 1990s. *See* Ex. E-1 at p. 46; *see also* Schedule 13G, BioSante Pharmaceuticals, Inc., Dec. 31, 2002, [attached as Exhibit H-1] (showing Morgenstern beneficial ownership of 7.5% of BioSante's outstanding common stock). Morgenstern became a director of BioSante in July 1999 as a representative of Starbow Investors in connection with a May 1999 private placement. *See* Form 10-SB, BioSante Pharmaceuticals, Inc., Dec. 23, 1999 [attached as Exhibit H-2], at 31, 37. At the time, BioSante was a privately held, unlisted penny-stock small business company. In 1999, 51.1% of BioSante's common stock was owned by 10 of its directors and officers and it had approximately 1,600 shareholders. *See* BioSante Pharmaceuticals, Inc., Form 10-SB, 28, 40 (Dec. 23, 1999) [attached as Exhibit H-2]. BioSante is currently listed on the American Stock Exchange.

38. Morgenstern has over $2 million invested in BioSante. Other investors in BioSante included at least two of Morgenstern's partners at Harris (Zuckerman and Anita Nagler) and three of the disinter-

ested trustees for the Funds (Wilner, who invested $50,000 in 1999 – now worth $141,000; Ruder, who invested $50,000 in 1999 for family members and currently owns additional stock through a partnership he manages; and Rotter, who has owned BioSante stock since 2001 – currently worth at least $75,000 – through a family partnership). These persons learned about BioSante from Morgenstern while he was at Harris. *See* Declaration of Victor Morgenstern, Jan. 14, 2006 [attached as Exhibit F-1], at ¶ 2; Declaration of Gary Wilner, Jan. 11, 2006 [attached as Exhibit F-2], at ¶ 2; Declaration of Burton Ruder, Jan. 14, 2006 [attached as Exhibit F-3)], at ¶¶ 2-4; Declaration of Marvin Rotter, Jan. 15, 2006 [attached as Exhibit F-4], at ¶ 2; Declaration of Sherwin Zuckerman, Jan. 31, 2006 [attached as Exhibit F-5], at ¶ 2; Ex. E-1 at pp. 30-31, 46-50; Ex. E-2 at pp. 59-60; Ex. E-4 at pp. 36-38, 49; Deposition of Marvin Rotter, Nov. 25, 2005 [attached as Exhibit E-6], at pp. 60-61, 57-59.

39. Jarvis Friduss also owns stock BioSante. *See* Ex. E-1 at p. 53.

5. Valor Equity Partners

40. In 2002 Morgenstern founded Valor, a private equity investment partnership that attracted about 30 investors. Morgenstern has invested over $2 million in Valor on an on call basis and has paid in over $1 million. Three partners at Harris (Nagler, Roxanne Martino and Anita Rosenberg) and one former partner (Zuckerman, in the amount of $550,000) have invested in Valor. Three disinterested trustees of the Funds have also invested in Valor, including Wilner and Ruder, who have each invested $125,000 on an on call basis and have paid in about $70,000 and $50,000, respectively, and Rotter, who has

invested $500,000 on an on call basis and has paid in about $275,000. All of these co-investors were invited into Valor by Morgenstern. *See* Ex. F-1 at ¶ 1; Ex. F-2 at ¶ 1; Ex. F-3 at ¶ 1, Ex. F-4 at ¶ 1; Ex. F-5 at ¶ 1; Ex. E-1 at pp. 10-11, 29-32, 49; Ex. E-2 at pp. 50-51, 71-72; Ex. E-4 at pp. 36, 40; Ex. E-6 at pp. 50-51.

41. Morgenstern's son is employed by Valor. *See* Ex. E-1 at p. 95.

6. Harris Alternatives

42. Morgenstern has invested millions of dollars in the following investment products: Aurora, L.P., Stellar, L.P., Perseus, L.P., Pleiades Offshore Fund Limited, and Aurora Offshore Fund Limited. These are hedge funds managed by Harris Alternatives, which was previously known as Harris Partners and is an affiliate of HALP. *See* Ex. F-1 at ¶ 4; Ex. E-1 at pp. 74, 84-85, 103. After Morgenstern retired from Harris, he continued to receive a discount on the fees he paid on Harris Alternatives investment vehicles. *See* Ex. E-1 at pp. 91-92. Harris Alternatives generated revenues that were included in the "C pool" from which Morgenstern's compensation from Harris was paid while he was an independent trustee. *See* Ex. E-1 at p. 20-21.

43. Wilner has invested in SPA Partners L.P., an investment product managed by Harris Alternatives. *See* Ex. F-2 at ¶ 4.

44. Rotter has invested in the Aurora Offshore Fund Limited, a hedge fund managed by Harris Alternatives and in which he believes Harris partners have invested. *See* Ex. F-4 at ¶ 4; Ex. E-6 at pp. 63-64.

7. Other Trustee Conflicts

45. Rotter and Zuckerman have been friends for 20 years. Rotter was a client of Zuckerman, and Zuckerman is married to Rotter's cousin. Rotter has shared in the following investments with Zuckerman: Valor, Walton Street, BioSante, and G-Tess. With regard to Walton Street, Zuckerman committed $1 million and Rotter committed $750K. Clyde McGregor, a Harris partner managed Rotter's $7-million account after Zuckerman retired from Harris and until Rotter moved his account back to Zuckerman after the expiration of a non-complete agreement between Zuckerman and Harris. Rotter was an advisory client of Harris's before he became a disinterested trustee, and was a neighbor, with children who were contemporaries, of Morgenstern's. Rotter came to be a trustee by way of an introduction by Zuckerman. *See* Ex. E-6 at pp. 44-51, 54-57, 65, 70.

46. Reich has provided legal representation to persons affiliated with Wanger Asset Management, the founder of which had been a Harris partner, and once represented Robert Levy, a Harris partner, in a commercial dispute. Reich knew Levy, Zuckerman and Szold before he became a trustee. Reich socialized with Levy, Reich's and Zuckerman's children schooled together, and Szold was Reich's father's broker. Reich has an IRA at Harris that is managed by Levy, and Levy recommended Reich for the Board of Trustees. *See* Deposition of Allan Reich, Nov. 11, 2005 [attached as Exhibit E-7], at pp. 9-10, 12-17, 20, 33.

47. Ruder had an account with Harris more than five years ago through which he bought stocks. *See* Ex. E-4 at pp. 67-68.

E. INDEPENDENCE OF THE TRUSTEES

48. Morgenstern participated in the independent trustees' evaluation of the advisory contracts and voted on the contracts from 2001 through 2004. *See, e.g.*, Ex. D-2 at pp. 6-7; Ex. D-4 at pp. 12-13.

49. When the Governance Committee evaluated Morgenstern's performance as chairman at the October 21, 2003 meeting, they approved his performance in part because he had "severed all his formal and financial ties to the advisors and was truly independent." *See* Minutes of Meeting of the Governance Committee of the Board of Trustees, October 21, 2003 (HA128740) [attached as Exhibit D-24], at p. 4. However, at least some of the independent directors knew this was not true. Wilner knew in 2003 through 2005, if not prior to that as well, that Harris was compensating Morgenstern at a time when Morgenstern was an independent director. *See* Ex. E-2 at p. 37. Ruder and Reich were also aware that Morgenstern received compensation from Harris after Morgenstern became an independent director. *See* Ex. E-4 at pp. 61, 64-66; Ex. E-7 at p. 38. Nonetheless, Wilner did not know how Morgenstern's compensation was calculated or whether it was based on Harris's revenues or profits, although he believed it would terminate if Harris ceased to exist. *See* Ex. E-2 at pp. 40-41. Nor was Ruder aware that Morgenstern's compensation could be affected by the amount of Harris's revenues. *See* Ex. E-4 at pp. 65-66. On the other hand, Friduss knew that Morgenstern received compensation and that it "was related in some way to the financial success that Harris had in a given year" and that there was a connection between the amount of the fees the directors negotiated and the amount of Morgenstern's compensation. *See* Ex.

E-5 at pp. 46-50. However, Friduss did not believe that this created even an appearance of a conflict. *See id.* at pp. 50-51.

50. Rotter and Reich were aware of Wilner's and Morgenstern's joint real estate investments in Colorado and Wisconsin, and Ruder was aware of the joint investment in Colorado. *See* Ex. E-6 at pp. 66; Ex. E-7 at pp. 27-28; Ex. E-4 at p. 46. Rotter was aware that Morgenstern was invested in Valor. *See* Ex. E-6 at pp. 51-52. Wilner knew that Ruder was also a Valor investor and that Zuckerman had some relation to Valor and that Ruder might also be an investor in BioSante. *See* Ex. E-2 at pp. 52-53, 60. Morgenstern was aware, of course, of his own joint investments with Wilner, Ruder, and Rotter and various Harris Partners. There is no evidence in the Record that the independent directors who might have been expected to investigate the more serious conflicts of their colleagues actually did so. *See* Ex. E-4 at p. 58 (Ruder stating that the board was not kept apprised of common investments between the Funds' directors and Harris partners). Friduss stated that the independent directors made a determination regarding their independence "in a formal way . . . through a questionnaire" but conceded that the board left it to independent counsel to review the questionnaires and report to the board if there were any problems. *See* Ex. E-5 at pp. 94-95.

51. Morgenstern's C-Plan compensation from Harris was never disclosed in the registration statements for the Funds. *See* Exs. C-1 to C-5.

52. The investments by Morgenstern, Wilner, and Rotter in investment products managed by Harris Alternatives were never disclosed in the registration statements for the Funds. *See* Exs. C-1 to C-5.

53. Harris executives attended virtually all of the meetings of the Management Contracts Committee. *See* Minutes of Meetings of the Management Contracts Committee of the Board of Trustees, May 1, 2002 (HA5315) [attached as Exhibit D-5], at p. 1 (Nagler, Raitt, Reali, Rowsell); May 14, 2002 (HA5319) [attached as Exhibit D-6], at p. 1 (Nagler, Raitt, Reali, Rowsell); June 25, 2002 (HA5056) [attached as Exhibit D-7], at p. 1 (Nagler, Raitt, Reali, Rowsell); July 12, 2002 (HA5061) [attached as Exhibit D-8], at p. 1 (Levy, Nagler, Reali, Raitt, Regan, Rowsell); Sep. 11, 2002 (HA5067) [attached as Exhibit D-9], at p. 1 (Levy, Nagler, Raitt, Reali, Rowsell); April 16, 2003 (HA2844) [attached as Exhibit D-10], at p. 1 (Nagler, Raitt, Reali, Rowsell); June 6, 2003 (HA2850) [attached as Exhibit D-11], at p. 1 (Nagler, Raitt, Reali, Rowsell); June 24, 2003 (HA2857) [attached as Exhibit D-12], at p. 1 (Nagler, Raitt, Reali, Regan, Rowsell, Raketich); Aug. 25, 2003 (HA2884) [attached as Exhibit D-13], at p.1 (Raitt, Reali, Rowsell, Raketich).

54. Harris executives attended virtually all of the meetings of the Governance Committee. *See* Minutes of Meetings of the Governance Committee of the Board of Trustees, Nov. 17, 1999 (HA84049) [attached as Exhibit D-14], at p. 1 (Morgenstern as a member); July 6, 2000 (IT00411) [attached as Exhibit D-15], at p. 1 (Morgenstern as a member, Regan, Fleischer); Jan. 17, 2001 (IT00465) [attached as Exhibit D-16], at p. 1 (Regan); July 18, 2001 (HA85772) [attached as Exhibit D-17], at p. 1 (Reali, Regan); Nov. 14, 2001 (IT00817) [attached as Exhibit D-18], at p. 1 (Regan, Reali); Jan. 16, 2002 (IT00858) [attached as Exhibit D-19], at p. 1 (Reali, Regan); April 17, 2002 (HA68584) [attached as Exhibit D-20],

at p. 1 (Regan, Reali); October 16, 2002 (IT01460) [attached as Exhibit D-21], at p. 1 (Raitt, Regan, Rowsell); Jan. 15, 2003 (IT01575) [attached as Exhibit D-22], at p. 1 (Raitt, Reali, Regan); July 16, 2003 (HA128810) [attached as Exhibit D-23], at p. 1 (Raitt, Reali, Regan); Ex. D-24 at p. 1 (Raitt, Reali, Regan); Ex. D-25 at p.1 (Raitt, Reali, Regan, Rowsell).

55. The independent trustees occasionally met in executive session, but this was rare. *See, e.g.*, Ex. D-11 at p. 4. The executives actively participated in most meetings. *See, e.g.*, Ex. D-7 at p. 3 (at June 25, 2002 Management Contracts Committee meeting, Nagler responding to question about the expense ratio for the Equity and Income Fund being higher than the Lipper peer group median).

Respectfully submitted,

By: /s/ JAMES C. BRADLEY

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September 12, 2006

EXHIBIT C-4

STATEMENT OF ADDITIONAL INFORMATION

January 31, 2004
As Supplemented February 11, 2004

THE OAKMARK FAMILY OF FUNDS

No-Load Funds

* * * * *

INVESTMENT ADVISER

The Adviser furnishes continuing investment supervision to the Funds and is responsible for overall management of the Funds' business affairs pursuant to investment advisory agreements relating to the respective Funds (the "Agreements'). The Adviser furnishes office space, equipment and personnel to the Funds, and assumes the expenses of printing and distributing the Funds' prospectus, profiles and reports to prospective investors.

Each Fund pays the cost of its custodial, stock transfer, dividend disbursing, bookkeeping, audit and legal services. Each Fund also pays other expenses such as the cost of proxy solicitations, printing and distributing notices and copies of the prospectus and shareholder reports furnished to existing shareholders, taxes, insurance premiums, the expenses of maintaining the registration of that Fund's shares under federal and state securities laws and the fees of trustees not affiliated with the Adviser.

For its services as investment adviser, the Adviser receives from each Fund a monthly fee based on that Fund's net assets at the end of the preceding month.

Basing the fee on net assets at the end of the preceding month has the effect of (i) delaying the impact of changes in assets on the amount of the fee and (ii) in the first year of a fund's operation, reducing the amount of the aggregate fee by providing for no fee in the first month of operation. The annual rates of fees as a percentage of each Fund's net assets are as follows:

Fund	Fee
Oakmark	1.00% up to $2.0 billion; .90% on the next $1.0 billion; .80% on the next $2.0 billion; and .75% on net assets in excess of $5.0 billion
Select	1.00% up to $1.0 billion; .95% on the next $500 million; .90% on the next $500 million; .85% on the next $500 million; .80% on the next $2.5 billion; and .75% on net assets in excess of $5.0 billion
Small Cap	1.00%
Equity and Income	0.75% up to $5 billion; 0.70% on the next $2.5 billion; 0.675% on the next $2.5 billion; and 0.65% on net assets in excess of $10 billion

Global	1.00% up to $2 billion; 0.95% on the next $2 billion; and 0.90% on net assets in excess of $4 billion
International	1.00% up to $2.0 billion; .95% on the next $1.0 billion; and .85% on net assets in excess of $3 billion
International Small Cap	1.25% up to $500 million; and 1.10% on net assets in excess of $500 million

The table below shows gross advisory fees paid by the Funds and any expense reimbursements by the Adviser to them, which are described in the prospectus.

Fund	Type of Payment	Year Ended September 30, 2003	Year Ended September 30, 2002	Year Ended September 30, 2001
Oakmark	Advisory fee	$37,074,474	$34,848,853	$25,662,135
Select	Advisory fee	38,938,068	40,838,462	27,774,016
Small Cap	Advisory fee Reimbursement	3,492,495 654	4,121,533 –	2,490,470 –
Equity and Income	Advisory fee	23,468,519	12,099,581	1,591,905
Global	Advisory fee Reimbursement	2,982,092 –	1,333,497 –	387,377 20,815
International	Advisory fee	19,015,386	12,048,977	8,269,717
International Small Cap	Advisory fee	4,626,713	3,860,436	1,238,024

The Agreement for each Fund was for an initial term that expired on October 31, 2001. Each Agreement continues from year to year thereafter so long as such continuation is approved at least annually by (1) the board of trustees or the vote of a majority of the outstanding voting securities of the Fund, and (2) a majority of the trustees who are not interested persons of any party to the Agreement, cast in person at a meeting called for the purpose of voting on such approval. Each Agreement may be terminated at any time, without penalty, by either the Trust or the Adviser upon 60 days' written notice, and automatically terminates in the event of its assignment as defined in the 1940 Act.

At a meeting of the board of trustees of the Trust held on October 21, 2003, called in part for the purpose of voting on the renewal of the Agreements, the Agreements were renewed through October 31, 2004 by the unanimous vote of the trustees present at the meeting, and the unanimous vote of the "non-interested" trustees of the Trust voting separately. The trustees considered information about, among other things:

- the Adviser and its personnel (including particularly those personnel with responsibilities for providing services to the Funds), resources and investment processes;
- the terms of each Agreement;
- the scope and quality of services that the Adviser has been providing to the Funds;
- the investment performance of each Fund and of comparable funds managed by other advisers over various periods;

- the advisory fee rates payable by each Fund to the Adviser and by comparable funds managed by other advisers;
- the total expense ratio of each Fund and of comparable funds managed by other advisers;
- the compensation payable by the Funds to affiliates of the Adviser for other services;
- the profitability of the Adviser and its affiliates from their relationships with the Funds; and
- the Adviser's use of the Funds' portfolio brokerage transactions to obtain research benefiting the Funds or other clients of the Adviser at a cost that may be in excess of the amount other brokers would charge.

The Adviser is a limited partnership managed by its general partner, Harris Associates, Inc. ("HAI"), whose directors are David G. Herro, Robert M. Levy, John R. Raitt, Kristi L. Rowsell, G. Neal Ryland and Peter S. Voss. Mr. Raitt is the president and chief executive officer of HAI. HAI is a wholly-owned subsidiary of CDC IXIS Asset Management North America, L.P. ("CDC IXIS AMNA"). CDC IXIS AMNA owns 99.67% of the limited partnership interests in the Adviser and, through its wholly-owned subsidiary, CDC IXIS Asset Management Holdings, Inc. ("CDC IXIS Holdings"), all of the outstanding shares of HAI. CDC IXIS AMNA is a limited partnership that owns investment management and related firms, including CDC IXIS Asset Management Services, Inc., the Funds' transfer agent.

CDC IXIS AMNA is an indirect wholly owned subsidiary of CDC IXIS Asset Management ("CDC AM"), which in turn is owned by CDC IXIS, a direct and indirect subsidiary of France's Caisse de Depots et

Consignations ("CDC"). Founded in 1816, CDC is a major diversified financial institution with a strong global presence in the banking, insurance, investment banking, asset management and global custody industries. CDC owns approximately 44% of CDC IXIS directly and 53% of CDC IXIS indirectly through its subsidiaries Eulia and Caisse Nationale des Caisses D'Epargne. CDC owns 50% of Eulia and 35% of Caisse Nationale des Caisses D'Epargne, which itself owns 50% of Eulia. Eulia owns 53% of CDC IXIS, which owns 80% of CDC IXIS AM. In addition to its ownership of CDC IXIS AM through CDC IXIS, CDC owns approximately 40% of CNP Assurances, a leading French insurance company, which itself owns 20% of CDC IXIS AM. The main place of business of CDC AM is 7, place des Cinq Martyrs du Lycée Buffon, 75015 Paris, France. The registered address of CDC IXIS is 56, rue de Lille, 75007 Paris, France. The registered address of CNP Assurances is 4, place Raoul Dautry, 75015 Paris, France. The registered address of Caisse National des Caisses d'Epargne is 5, rue Masseran, 75007 Paris, France.

The Adviser has contractually agreed to reimburse Class I Shares of each Fund to the extent that the annual ordinary operating expenses of that class exceed the following percentages of the average net assets of Class I Shares: 1.50% in the case of Oakmark Fund, Select Fund or Small Cap Fund; 1.00% in the case of Equity and Income Fund; 1.75% in the case of Global Fund; and 2.00% in the case of International Fund and International Small Cap Fund. The Adviser has also contractually agreed to reimburse Class II Shares of each Fund to the extent that the annual ordinary operating expenses of that class

exceed the following percentages of the average net assets of Class II Shares: Oakmark Fund, Select Fund or Small Cap Fund, 1.75% (1.50% + .25%); Equity and Income Fund, 1.25% (1.00% + .25%); Global Fund, 2.00% (1.75% + .25%); and International Fund and International Small Cap Fund, 2.25% (2.00% + .25%). Each such agreement is effective through January 31, 2005.

For the purpose of determining whether a share class of a Fund is entitled to any reduction in advisory fee or expense reimbursement, the pro rata portion of the Fund's expenses attributable to a share class of that Fund is calculated daily and any reduction in fee or reimbursement is made monthly.

* * * * *

TRUSTEES AND OFFICERS

The board of trustees has overall responsibility for the Funds' operations. Each of the trustees and officers serves until the election and qualification of his or her successor, or until he or she sooner dies, resigns, or is removed or disqualified. The retirement age for trustees is 72. Information regarding the trustees and officers of the Trust including their principal business activities during the past five years is set forth below:

Trustees Who Are Not Interested Persons of the Trust

Name, Address* and Age at December 31, 2003	Position(s) with Trust	Date First Elected or Appointed to Current Office	Principal Occupation(s) Held During Past Five Years*	Number of Portfolios in Fund Overseen by Trustee	Other Directorships Held by Trustee
Victor A. Morgenstern, 61	Trustee and Chairman of the Board of Trustees	1991	President, Resolute Advisors, Inc. (private investment management firm) since 2002; Chairman Valor Equity Partners, LLC (private equity fund) since 2002; Managing Partner, Drill Hall Partners LLC; Chairman of the Board, HAI, 1995 – 2000; President and Chief Executive Officer prior thereto; Chairman, Harris Partners, L.L.C., 1995 – 2000	7	Trustee, Illinois Institute of Technology (educational institution); Director, Bro Santa Pharmaceuticals Inc. (developer of hormone therapy products)
Michael J. Kirkland, 69	Trustee	1995	Principal, MJ Fridays & Associates, Inc. (telecommunications consultants)	7	None
Thomas H. Hayden, 62	Trustee	1995	President, Greenhouse Communications (advertising agency) since 2004; Executive Vice President, Campbell Hilton, prior thereto (advertising and marketing communication agency)	7	None
Christine M. Maki, 43	Trustee	1996	Vice President—Tax, Hyatt Corporation (hotel management)	7	Director, Illinois CPA Society
Allan J. Helch, 55	Trustee	1993	Partner, Seyfarth Shaw LLP (law firm) since 2003; Vice Chairman of the law firm D'Ancona & Pflaum LLC, prior thereto	7	None
Mary H. Heffer, 57	Trustee	1996	Senior Advisor to Chief Executive Officer, AXA Advisors, LLC (formerly named Roller & Associates)	7	None
Burton W. Ruder, 60	Trustee	1995	President, The Academy Financial Group (venture capital investment and transaction financing firm); Manager, Cedar Green Associates (real estate management firm)	7	None
Gary N. Wilner, M.D., 63	Trustee	1993	Senior Attending Physician, Evanston Hospital; Medical Director – Cardio Pulmonary Wellness Program, Evanston Hospital Corporation	7	Director, North American Scientific, Inc. (developer of radioisotopic products for the treatment and diagnosis of disease)

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Trustees Who are Interested Persons of the Trust

Name, Address* and Age as December 31, 2007	Position(s) with Trust	Date First Elected or Appointed to Current Office	Principal Occupation(s) Held During Past Five Years*	Number of Portfolios in Fund Complex Overseen by Trustee	Other Directorships Held by Trustee
Peter S. Voss*, 57	Trustee	1995	President and Chief Executive Officer, CDC IXIS Asset Management North America, L.P., formerly known as Nvest Companies, L.P. and its predecessor firms (investment management); Director, HAI	7	Chairman, ADW Real Estate Income Fund (closed-end investment company); Chairman and Chief Executive Officer, CDC Nvest Funds (open-end investment company – 14 portfolios)
John H. Ruffin*, 45	Trustee and President	2003–c	President and Chief Executive Officer, HAI, HASI P and HALP, since 2002; Chief Operating Officer, HALP 2001–2002; Director of Research, HALP 1998 – 2002; and Associate Director of Research, HALP, prior thereto	1	

APPENDIX B – FINANCIAL STATEMENTS

THE OAKMARK FUND

Schedule of Investments—September 30, 2003 cont.

Name	Par Value	Market Value
Short Term Investments—8.4% (cont.)		
U.S. Government Bills—5.0%		
United States Treasury Bills, 0.845% - 0.93% due 10/2/2003 - 11/28/2003	$240,000,000	$239,824,096
Total U.S. Government Bills (Cost: $239,816,491)		**239,824,096**
Repurchase Agreements—3.4%		
IBT Repurchase Agreement, 0.95% due 10/1/2003, repurchase price $160,004,222, collateralized by U.S. Government Agency Securities	160,000,000	160,000,000
IBT Repurchase Agreement, 0.75% due 10/1/2003, repurchase price $1,752,013, collateralized by U.S. Government Agency Securities	1,751,976	1,751,976
Total Repurchase Agreements (Cost: $161,751,976)		**161,751,976**
Total Short Term Investments (Cost: $401,568,467)		**401,576,072**
Total Investments (Cost $4,266,323,209)—100.1%		$4,793,131,525
Other Liabilities In Excess Of Other Assets—(0.1%)		(2,616,390)
Total Net Assets—100%		**$4,790,515,135**

(a) Non-income producing security.

(b) Represents an American Depository Receipt.

(c) See footnote number five in the Notes to Financial Statements regarding transactions in securities of affiliated issuers.

(d) Effective October 16, 2003, AOL Time Warner Inc. changed its name to Time Warner Inc.

(e) Represents a foreign domiciled corporation.

THE OAKMARK EQUITY AND INCOME FUND

Schedule of Investments—September 30, 2003 cont.

Name	Contracts Held	Market Value
Call Options Purchased—0.0%		
Banks & Thrifts—0.0%		
First Health Group Corp., January 30 Calls	420	$22,050
First Health Group Corp., October 30 Calls	170	2,550
		24,600
Areospace & Defense—0.0%		
General Dynamics Corporation, November 80 Calls	2,548	$522,340
Total Call Options Purchased (Cost: $431,250)—0.0%		**$546,940**
Other Assets In Excess Of Other Liabilities—(0.7%)		31,807,514
Total Net Assets—100%		**$4,384,649,011**

(a) Non-income producing security.

(b) Represents an American Depository Receipt.

(c) Represents a foreign domiciled corporation.

(d) See footnote number five in the Notes to Financial Statements regarding transactions in securities of affiliated issuers.

THE OAKMARK GLOBAL FUND

Schedule of Investments—September 30, 2003 cont.

Name	Description	Shares Subject to Call	Market Value
Call Options Written—0.0%			
Information Services—0.0%			
eFunds Corporation, December 15 Calls (United States)	Electronic Debit Payment Services	(100,000)	$ (22,500)
Computer Software—0.0%			
Synopsys, Inc., December 35 Calls (United States)	Electronic Design Automation	(100,000)	$ (22,500)
Total Call Options Written (Premiums Received: $(175,242))—0.0%			**(102,500)**

Name	Description	Shares Subject to Call	Market Value
Put Options Written—0.0%			
Computer Software—0.0%			
Synopsys, Inc., December 27.50 Puts (United States)	Electronic Design Automation	(100,000)	$ (105,000)
Total Put Options Written (Premiums Received: $(80,746))—0.0%			**(105,000)**
Other Liabilities In Excess Of Other Assets—(1.46%)			(9,851,103)
Total Net Assets—100%			**$710,597,435**

(a) Non-income producing security.

(b) See footnote number five in the Notes to Financial Statements regarding transactions in securities of affiliated issuers.

(c) Represents an American Depository Receipt.

(d) Effective October 16, 2003, AOL Time Warner Inc. changed its name to Time Warner Inc.

(e) A portion of this security has been segregated to cover written option contracts.

EXHIBIT C-5

STATEMENT OF ADDITIONAL INFORMATION

January 28, 2005

THE OAKMARK FUNDS

No-Load Funds

* * * * *

INVESTMENT ADVISER

The Adviser furnishes continuing investment supervision to the Funds and is responsible for overall management of the Funds' business affairs pursuant to investment advisory agreements relating to the respective Funds (the "Agreements"). The Adviser furnishes office space, equipment and personnel to the Funds, and assumes the expenses of printing and distributing the Funds' prospectus, profiles and reports to prospective investors.

Each Fund pays the cost of its custodial, stock transfer, dividend disbursing, bookkeeping, audit and legal services. Each Fund also pays other expenses such as the cost of proxy solicitations, printing and distributing notices and copies of the prospectus and shareholder reports furnished to existing shareholders, taxes, insurance premiums, the expenses of maintaining the registration of that Fund's shares under federal and state securities laws and the fees of trustees not affiliated with the Adviser.

For its services as investment adviser, the Adviser receives from each Fund a monthly fee based on that Fund's net assets at the end of the preceding month. Basing the fee on net assets at the end of the preced-

ing month has the effect of (i) delaying the impact of changes in assets on the amount of the fee and (ii) in the first year of a fund's operation, reducing the amount of the aggregate fee by providing for no fee in the first month of operation. The annual rates of fees as a percentage of each Fund's net assets are as follows:

Fund	Fee
Oakmark	1.00% up to $2.0 billion; 0.90% from $2-3 billion; 0.80% from $3-5 billion; 0.75% from $7.5-10 billion; and 0.65% over $10 billion
Select	1.00% up to $1.0 billion; 0.95% from $1-1.5 billion; 0.90% from $1.5-2 billion; 0.85% from $2-2.5 billion; 0.80% from $2.5-5 billion; 0.75% from $5-10 billion; and 0.725% over $10 billion
Equity and Income	0.75% up to $5 billion; 0.70% from $5-7.5 billion; 0.675% from $7.5-10 billion; 0.65% from $10-12.5 billion; and 0.60% over $12.5 billion
Global	1.00% up to $2 billion; 0.95% from $2-4 billion; and 0.90% over $4 billion

International	1.00% up to $2.0 billion; 0.95% from $2-3 billion; 0.85% from $3-5 billion; 0.825% from $5-7.5 billion; 0.815% over $7.5 billion
International Small Cap	1.25% up to $500 million; 1.10% from $500 million to $1.5 billion; and 1.05% over $1.5 billion

The table below shows gross advisory fees paid by the Funds and any expense reimbursements by the Adviser to them, which are described in the prospectus.

Fund	Type of Payment	Year Ended September 30, 2004	Year Ended September 30, 2003	Year Ended September 30, 2002
Oakmark	Advisory fee	$50,652,178	$37,074,474	$34,848,853
Select	Advisory fee	48,070,958	38,938,068	40,838,462
Equity and Income	Advisory fee	46,997,810	23,468,519	12,099,581
Global	Advisory fee	12,245,761	2,982,092	1,333,497
International	Advisory fee	36,337,644	19,015,386	12,048,977
International Small Cap	Advisory fee	7,616,526	4,626,713	3,860,436

The Agreement for each Fund was for an initial term that expired on October 31, 2001. Each Agreement continues from year to year thereafter so long as such continuation is approved at least annually by (1) the board of trustees or the vote of a majority of the outstanding voting securities of the Fund, and (2) a majority of the trustees who are not interested

persons of any party to the Agreement, cast in person at a meeting called for the purpose of voting on such approval. Each Agreement may be terminated at any time, without penalty, by either the Trust or the Adviser upon 60 days' written notice, and automatically terminates in the event of its assignment as defined in the 1940 Act.

At a meeting of the board of trustees of the Trust held on October 28, 2004, called in part for the purpose of voting on the renewal of the Agreements, the Agreements, with certain restrictions in the schedule of advisory fee rates, were renewed through October 31, 2005 by the affirmative vote of a majority of the trustees, and a majority of "non-interested" trustees, voting separately. The trustees considered information about, among other things:

- the Adviser and its personnel (including particularly those personnel with responsibilities for providing services to the Funds), resources and investment processes;
- the terms of each Agreement;
- the scope and quality of services that the Adviser has been providing to the Funds;
- the investment performance of each Fund and of comparable funds managed by other advisers over various periods;
- the advisory fee rates payable by each Fund to the Adviser and by comparable funds managed by other advisers, as well as advisory fee rates payable by other types of accounts managed by the Adviser;
- the total expense ratio of each Fund and of comparable funds managed by other advisers;

- the compensation payable by the Funds to affiliates of the Adviser for other services, and the Adviser's contractual undertaking to limit Fund expenses;
- the profitability of the Adviser and its affiliates from their relationships with the Funds, as well as economies of scale and sharing of those economies with the Funds; and
- the Adviser's use of the Funds' portfolio brokerage transactions to obtain research benefiting the Funds or other clients of the Adviser at a cost that may be in excess of the amount other brokers would charge.

The action of the trustees to renew the Agreements was taken upon recommendation of the committee on management contracts, which had met several times over the preceding five months, and was taken after successive board meetings at which the agreements were discussed.

The Adviser is a limited partnership managed by its general partner, Harris Associates, Inc. ("HAT"), whose directors are David G. Herro, Robert M. Levy, John R. Raitt, Kristi L. Rowsell, G. Neal Ryland and Peter S. Voss. Mr. Raitt is the president and chief executive officer of HAI. HAI is a wholly-owned subsidiary of IXIS Asset Management North America, L.P. ("IXIS AMNA"). IXIS AMNA owns 99.67% of the limited partnership interests in the Adviser and, through its wholly-owned subsidiary, IXIS Asset Management Holdings, LLC ("IXIS Holdings"), all of the outstanding shares of HAI. IXIS AMNA is a limited partnership that owns investment management and distribution and service entities, including IXIS Asset Management Services Company, the Funds' transfer agent.

IXIS ANNA is part of IXIS Asset Management Group, an international asset management group based in Paris, France. IXIS Asset Management Group is ultimately owned principally, directly or indirectly, by three large affiliated French financial services entities: the Caisse des Depots et Consignations ("CDC"), a public sector financial institution created by the French government in 1816; the Caisse Nationale des Caisses d'Epargne ("CNC"), a financial institution owned by CDC and by French regional savings banks known as the Caisses d'Epargne; and CNP Assurances, a large French life insurance company. The registered address of CNC is 5, rue Masseran, 75007 Paris, France. The registered office of CDC is 56, rue de Lille, 75007 Paris, France. The registered address of CNP Assurances is 4, place Raoul Dautry, 75015 Paris, France.

The Adviser has contractually agreed to reimburse Class I Shares of each Fund to the extent that the annual ordinary operating expenses of that class exceed the following percentages of the average net assets of Class I Shares: 1.50% in the case of Oakmark Fund or Select Fund; 1.00% in the case of Equity and Income Fund; 1.75% in the case of Global Fund; and 2.00% in the case of International Fund and International Small Cap Fund. The Adviser has also contractually agreed to reimburse Class II Shares of each Fund to the extent that the annual ordinary operating expenses of that class exceed the following percentages of the average net assets of Class II Shares: Oakmark Fund or Select Fund, 1.75% (1.50% + .25%); Equity and Income Fund, 1.25% (1.00% + .25%); Global Fund, 2.00% (1.75% + .25%); and International Fund and International

Small Cap Fund, 2.25% (2.00% + .25%). Each such agreement is effective through January 31, 2006.

For the purpose of determining whether a share class of a Fund is entitled to any reduction in advisory fee or expense reimbursement, the pro rata portion of the Fund's expenses attributable to a share class of that Fund is calculated daily and any reduction in fee or reimbursement is made monthly.

* * * * *

EXHIBIT D-1

HARRIS ASSOCIATES INVESTMENT TRUST

The Oakmark Fund
The Oakmark Select Fund
The Oakmark Small Cap Fund
The Oakmark Equity and Income Fund
The Oakmark Global Fund
The Oakmark International Fund
The Oakmark International Small Cap Fund

Minutes of Meeting of Board of Trustees

January 17, 2001

A regular meeting of the board of trustees of Harris Associates Investment Trust, a Massachusetts business trust (the "Trust"), was held at 1:00 p.m. on Wednesday, January 17, 2001, at the offices of the Trust, Suite 500, Two North LaSalle Street, Chicago, Illinois 60602, upon call of the chairman of the Trust and pursuant to notice.

All of the trustees, except Peter S. Voss, constituting a quorum, were present as follows:

Michael J. Friduss
Thomas H. Hayden
Christine M. Maki
Victor A. Morgenstern
Allan J. Reich
Burton W. Ruder
Mary R. Rotter
Gary N. Wilner, M.D.

Also present were John J. Kane, Robert M. Levy, Anita M. Nagler, Ann W. Regan and Kristi L.

Rowsell, officers of the Trust; Stephen J. Fleischer, an employee of Harris Associates L.P. (the "Adviser"); and Cameron S. Avery and Sarah A. Johnson of Bell, Boyd & Lloyd LLC, counsel to the Trust and the non-interested trustees. Mr. Friduss participated in the meeting by conference telephone by means of which all persons participating in the meeting could hear each other. Mr. Morgenstern was chairman and Ms. Nagler was secretary of the meeting.

* * * * *

Governance Committee. Mr. Ruder reviewed the results of the governance committee meeting that was held earlier. He stated that the committee was proposing several changes, including: (i) creating the position of Chairman of the Board of the Trust and eliminating the office of Chairman of the Trust; (ii) designating Mr. Morgenstern as the Chairman of the Board of the Trust, to serve until his successor was duly designated or he no longer is able or willing to serve; (iii) setting compensation for the position of the Chairman of the Board at $50,000 per year in addition to the regular retainer for independent trustees; (iv) amending the description for the office of the President of the Trust to include performing the duties of the Chief Executive Officer of the Trust; (v) amending the bylaws to provide for the nomination of non-interested trustees by the non-interested trustees; and (vi) amending the description of the governance committee to include responsibility for making recommendations with respect to improving board effectiveness.

Mr. Avery noted that on January 1, 2001 Mr. Morgenstern ceased to be affiliated with the Adviser, but he remained an "interested" trustee of the Trust (as defined in the Investment Company Act of 1940)

because, as chairman of the Trust, he was the chief executive officer of the Trust as specified in the by-laws. If the trustees approved the changes to the Trust's bylaws, Mr. Morgenstern would no longer be considered an interested trustee. However, during the next two fiscal years, the Securities and Exchange Commission, after an opportunity for a hearing, could issue an order determining that Mr. Morgenstern was an interested trustee because he had a material business relationship with the Adviser. Mr. Avery said that such an order was unlikely and that any determination would be effective only prospectively, rather than retrospectively. As a non-interested trustee, Mr. Morgenstern would be entitled to compensation in accordance with the Trust's compensation policies.

Mr. Reich stated that, at the earlier meeting, the trustees, other than Mr. Morgenstern, had discussed their expectations with respect to the Chairman position. He suggested that the trustees re-evaluate the rote and duties of the Chairman on an annual basis. Mr. Rotter agreed with Mr. Reich and stated his belief that due to Mr. Morgenstern's former position with the Adviser he would be helpful to the board in working with the Adviser. Mr. Morgenstern stated that he appreciated the confidence that the other trustees had placed in him and would be vigilant in his duties as Chairman.

Mr. Ruder then reviewed the governance committee's recommendations with respect to the Trust's committees. The committee concluded to recommend to the board that the chair of any committee normally serve as chair for two consecutive years and that committee membership be reviewed on an annual basis. Mr. Ruder also noted that the governance

committee recommended the following committee assignments:

Committee	Members
Executive	Morgenstern, Chair Voss Wilner
Audit	Maki, Chair Friduss Hayden Reich
Governance	Ruder, Chair Maki Morgenstern Reich Wilner
Management Contracts	Friduss, Chair Hayden Morgenstern Rotter Ruder
Pricing	Levy Nagler Rowsell

After further discussion and upon motion duly made and seconded, the following resolutions were adopted by the affirmative vote of all of the trustees present at the meeting:

Committee Assignments

RESOLVED, that Victor A. Morgenstern, Peter S. Voss, and Gary N. Wilner are appointed as the members of the executive committee of the board of trustees of Harris Associates Investment Trust (the "Trust"), to serve at the pleasure of the board, with Victor A. Morgenstern as the chair of the committee.

RESOLVED FURTHER, that Christine M. Maki, Man J. Reich, Thomas H. Hayden, and Michael J. Friduss are appointed as the members of the audit committee of the board of trustees of the Trust, to serve at the pleasure of the board, with Christine M. Maki as the chair of the committee.

RESOLVED FURTHER, that Michael J. Friduss, Mary R. Rotter, Thomas H. Hayden, Burton W. Ruder and Victor A. Morgenstern are appointed as the members of the committee on management contracts of the board of trustees of the Trust, to serve at the pleasure of the board, with Michael J. Friduss as the chair of the committee.

RESOLVED FURTHER, that Robert M. Levy, Anita M. Nagler, and Kristi L Rowsell are appointed as the members of the pricing committee of the board of trustees of the Trust, to serve at the pleasure of the board; provided that in the absence of any two members, the remaining member may designate any other officer as an alternate member, who, together with the regular member shall have authority to take action on behalf of the committee, except that no alternate member may act with respect to any security of a Fund for which the alternate member is a portfolio manager or co-manager.

RESOLVED FURTHER, that Christine M. Maki, Victor A. Morgenstern, Burton W. Ruder, Allan J. Reich and Gary N. Wilner are appointed as the

members of the governance committee of the board of trustees of the Trust, to serve at the pleasure of the board, with Burton W. Ruder as the chair of the committee.

RESOLVED FURTHER, that Victor A. Morgenstern is designated as chairman of the board of the Trust, to serve at the pleasure of the board.

Amendment of Bylaws

RESOLVED, that the proposed amended and restated bylaws of the Trust, in the form presented to this meeting, are adopted as the bylaws of the Trust, and the secretary shall identify such form of bylaws and file it with the records of the Trust.

Governance Committee Charter

RESOLVED, that the proposed charter of the governance committee of the board of trustees of the Trust, in the form presented to this meeting, is adopted as the charter of the committee, and the secretary shall identify such form of charter and file it with the records of the Trust.

* * * * *

/s/ ANITA M. NAGLER
Anita M. Nagler
Secretary

Approved:

/s/ VICTOR A. MORGENSTERN
Victor A. Morgenstern
Chairman

EXHIBIT D-4

HARRIS ASSOCIATES INVESTMENT TRUST

The Oakmark Equity and Income Fund
The Oakmark Fund
The Oakmark Global Fund
The Oakmark International Fund
The Oakmark International Small Cap Fund
The Oakmark Select Fund
The Oakmark Small Cap Fund

Minutes of Meeting of Board of Trustees

October 21, 2003

A regular meeting of the board of trustees of Harris Associates Investment Trust, a Massachusetts business trust (the "Trust"), was held at 1:00 p.m. on Tuesday, October 21, 2003, at the offices of the Trust, Suite 500, Two North LaSalle Street, Chicago, Illinois 60602, upon call of the chairman of the Trust and pursuant to notice.

All of the trustees, constituting a quorum, were present as follows:

Michael J. Friduss
Thomas H. Hayden
Christine M. Maki
Victor A. Morgenstern
John A. Raitt
Allan J. Reich
Marv R. Rotter
Burton W. Ruder
Peter S. Voss
Gary N. Wilner, M.D.

Also present for all or a portion of the meeting were John J. Kane, Robert M. Levy, Vineeta D. Raketich, Janet L. Reali, Ann W. Regan, and Kristi L. Rowsell, officers of the Trust; Jeffrey D. Plunkett, General Counsel of CDC IXIS Asset Management; and Cameron S. Avery and Mary T. Capasso of Bell, Boyd & Lloyd LLC ("Bell Boyd"), counsel to the Trust and the non-interested trustees. Mr. Morgenstern acted as chairman and Ms. Reali was secretary of the meeting. Ms. Maki participated in the meeting via conference telephone by means of which all persons participating in the meeting could hear each other.

* * * * *

Committee on Management Contracts. Mr. Hayden reported that the committee on management contracts had met in August to further review the investment advisory agreements for the various Funds with the Adviser. He stated that the committee had met specifically to review the fee schedules of the Funds and to further examine whether breakpoints should be added for the Funds that currently did not have a breakpoint schedule. He referred the board to the minutes of the meeting that were included in the board materials and noted that the minutes accurately reflected the committee's recommendations for changes to the fee schedules for The Oakmark Global Fund and The Oakmark Equity and Income Fund. He said he believed that his and the committee's discussions with Mr. Raitt and the Adviser during the review process had been very productive. He also noted that the committee would continue to review the fee schedules to determine whether further changes might be warranted. He stated that the committee had recommended the continuation of the advisory contracts, with such

changes to the fee schedules as noted in the meeting materials. Mr. Hayden also stated that the committee unanimously recommended the continuation of the distribution agreement.

After discussion, the following resolutions were adopted by the affirmative vote of (a) all of the trustees and (b) Ms. Maki and Messrs. Friduss, Hayden, Morgenstern, Reich, Rotter, Ruder and Wilner, all of the trustees who were not interested persons of the Trust, the Adviser or HASL, voting separately:

RESOLVED, that the continuation until October 31, 2004 of each investment advisory agreement for the respective series of the Trust is approved, subject to the terms of each such agreement, except that effective November 1, 2003, the agreement for The Oakmark Global Fund shall be amended to retain the annual rate of advisory fee of 1.00% of the Fund's average annual net assets up to $2 billion and then reduce the fee to 0.95% on the next $2 billion, and 0.90% on net assets in excess of $4 billion; and the agreement for The Oakmark Equity and Income Fund shall be amended to retain the annual rate of advisory fee of 0.75% of the Fund's average annual net assets up to $5 billion and then to reduce the fee to 0.70% on the next $2.5 billion; 0.675% on the next $2.5 billion; and 0.65% on net assets in excess of $10 billion.

RESOLVED FURTHER, that the continuation until October 31, 2004 of the distribution agreement of the Trust is approved, subject to the terms of the agreement.

* * * * *

/s/ JANET L. REALI
Janet L. Reali
Secretary

Approved:

/s/ VICTOR A. MORGENSTERN
Victor A. Morgenstern
Chairman

EXHIBIT E-1

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF VICTOR A. MORGENSTERN

September 23, 2005

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[16]

* * * * *

Q. Okay. And what was the term or terms of the deferred compensation that you got when you retired from Harris Associates?

A. The –

MR. RECHTORIS: Hold on. Can we have an understanding that if we're going to talk about dollar terms that it will be confidential and not used outside of this deposition?

MR. BRICKMAN: Yes, other than as needed in court.

MR. RECHTORIS: Understood.

MR. BRICKMAN: I mean –

MR. RECHTORIS: Right. I don't want to publicize, you know, dollar terms of what he's getting. If you need it for the case, so be it but –

MR. BRICKMAN: I understand.

MR. RECHTORIS: Is that –

MR. BRICKMAN: Fair enough.

MS. FELICELLO: We have a confidentiality order in place –

[17]

MR. RECHTORIS: Okay.

MS. FELICELLO: (Continuing) – so we can mark this transcript confidential.

MR. RECHTORIS: Thank you. Sorry to interrupt. Go ahead.

MR. BRICKMAN: It may give him bragging rights. I don't know.

BY MR. BRICKMAN:

Q. All right. I'm sorry, Mr. Morgenstern. Go ahead, sir.

A. The way in which the deferred comp plan worked was prior to retiring, people who were considered partners received a certain number of what we called C units. The C units were entitled to payments based on 10 percent of revenues of the firm.

At the time of one's retirement, there was an amount of money that was fixed, which was based on the prior – the prior payments on the C units that one owned. And so at the time of my – at my retire-

ment, the firm – based on the past payments on C units – fixed an amount of money that would have been due me and paid over a subsequent period of time.

[18]

The intention of the plan was to pay those units out over a six-year period – to pay the fixed amount over a six-year period. And in the event that they couldn't be paid over the six-year period because of certain restrictions on the amounts of payment, they – that period could be extended to ten years.

Q. How could it be extended to ten years? What restrictions would apply that would stretch it from six years to ten years?

A. The restrictions on the payments were that the sum total of payments to all retired participants from the firm could not exceed 30 percent of the payments into the plan in any given year or the pool from which the plan payments were made in any given year.

Q. Is this the C pool?

A. Correct.

Q. So that if the retired partners' amount of money taken out exceeded or reached 30 percent, that would stop how much money was paid out to retired partners for that year?

A. That's correct.

Q. And then what would happen to the amount [19] that was owed from that year?

A. It was deferred to the next year or – you know, or whenever it could be paid. But that after – if it wasn't paid within four years after the expiration of the sixth year, it would be lost.

Q. And what was the amount that you understood was to be paid to you over the six- to ten-year time period when you retired, sir?

A. The amount would have been about $625,000 per year.

Q. And when you say "would have been," has that, in fact, been paid to you?

A. Yes.

Q. Okay. So every year since you've retired you have received somewhere around $625,000 a year?

A. That's correct.

Q. And that comes out of the C pool?

A. That's correct.

* * * * *

[62]

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BY MR. BRICKMAN:

Q. With regard to the present board of trustees of the Oakmark funds, did you know those individuals before they became trustees?

A. I knew some of the individuals, not all of the individuals, before they became trustees.

Q. Which ones did you know before they became trustees?

A. The ones that I knew were Dr. Wilner, Michael Friduss, Burt Ruder. I knew Mary Rotter. I think that's it.

Q. Okay. Were you the one that invited these people to be on the board?

A. The – the independent trustees that currently serve on the board were selected by Harris Partners as a group. It was my recommendation to the part-

ners of Harris at the time that each partner submit a list of people that they thought would be appropriate trustees.

Various then-partners in the firm wound up recommending trustees, you know, to the – to the group and we've added them. So, for example, [63] Roxanne Martino wound up suggesting Chris Maki as a trustee. Bob Levy wound up suggesting Allan Reich as a trustee. Sherwin Zuckerman wound up suggesting Mary Rotter as a trustee. Robert Sanborn wound up suggesting Tom Hayden as a trustee. I wound up suggesting Gary Wilner, Mike Friduss, and Burt Ruder as trustees.

Q. I missed one. Who did Mr. Levy – oh, Allan Reich?

A. Yes.

* * * * *

EXHIBIT E-2

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF GARY N. WILNER

September 13, 2005

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[37]

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Q. Okay. During the entire time he was supposed to be an independent director, were you aware he was receiving income from Harris Associates?

MS. FELICELLO: Objection.

MR. WALSEN: Object to the form.

THE WITNESS: I don't know that I can answer for the entire time, but for a period of time.

BY MR. BRICKMAN:

Q. When did you find out that he was receiving monies from Harris Associates during the time he was an independent director?

A. I don't know that I can answer that specifically. It – I – I don't know.

Q. Was it this year?

A. I knew this year. I think I knew it before.

Q. Do you think you knew in the year '04 that he was receiving money from Harris Associates?

A. I knew in '04, yes.

Q. How about '03?

A. I believe so.

* * * * *

[40]

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BY MR. BRICKMAN:

Q. Did you know during the time period that he was an independent director that his deferred compensation was based on a formula that took into account revenues and profits of Harris Associates?

MR. WALSEN: Object, form.

MS. FELICELLO: Objection, lack of foundation.

THE WITNESS: As I said, I did know that he received income and that that income – it was my understanding that that income would continue at the level wherever it was, unless Harris [41] Associates basically ceased to exist.

BY MR. BRICKMAN:

Q. That's not my question, Dr. Wilner. Did you know during the time period he was supposed to be an independent director that his income or monies

from Harris Associates was based on a formula such that the more revenues Harris Associates received, the more monies Mr. Morgenstern would get – would get –

MS. FELICELLO: Objection.

BY MR. BRICKMAN:

Q. (Continuing) – in deferred compensation?

MS. FELICELLO: Objection.

BY MR. BRICKMAN:

Q. Did you know that, sir?

MS. FELICELLO: Objection, lack of foundation.

MR. WALSEN: Objection; form, foundation.

BY MR. BRICKMAN:

Q. When did you find that out, sir?

A. I don't know that I know that now.

Q. It's the first time you've heard that?

A. If what you're telling me is true, it's [42] the first time I heard that.

* * * * *

EXHIBIT E-3

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF KRISTI LINEBURG ROWSELL

November 28, 2005

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* * * * *

[88]

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BY MR. BRICKMAN:

Q. Now, after you look at it, if you'd be kind enough to tell me what that is.

A. I recognize this document as a calculation of C plan compensation.

Q. All right. And again, just for the record, what is the C plan?

A. The C plan is a deferred compensation plan for partners at Harris Associates.

Q. All right. What page do you have in front of you now?

A. Bates No. S 000124690.

Q. And this is apparently for the year [89] that ended 12/31/04.

A. That's correct.

Q. All right. And there are, in that – on that first page, a number of people that are listed as deferred payees; correct?

A. That's correct.

Q. Those are people that are no longer employed by Harris Associates; correct?

A. With the exception of David Herro, that is correct.

Q. Okay. Is there a reason Mr. Herro is in there, even though he's still employed – employed?

A. Yes. You – partners are entitled to deferred compensation on vested units taken away regardless of their status of employment. So David Herro had vested units taken away at some point, and therefore a deferred type – deferred comp entitlement was created.

Q. Okay. One of the people on there is a V. Morgenstern. That's Victor Morgenstern?

A. That's correct.

Q. All right. And he was formerly employed by Harris Associates; correct?

[90]

A. That's correct.

Q. And then he became a supposedly disinterested director or trustee; correct?

MS. FELICELLO: Objection to "supposedly."

THE WITNESS: Victor Morgenstern became a disinterested director. That's correct.

BY MR. BRICKMAN:

Q. And apparently he was paid for the year 2004, I guess, $632,125?

A. That's correct.

Q. And does that number that he's paid fluctuate each year?

A. It does not.

Q. Okay.

A. It could fluctuate if there were – there are limits in the plan, and if limits were hit, it could go down.

Q. Meaning if you didn't have enough revenues?

A. If we didn't have enough revenue to cover the deferred comp and minimum entitlement, then it could go down. But it could not – could not go up.

Q. All right. Let me show you what we [91] will mark as Exhibit 12 to your deposition, which begins with HAS 000124713 and goes through 124733.

(Whereupon Rowsell Deposition Exhibit No. 12 was marked as requested.)

BY MR. BRICKMAN:

Q. That is the same basic document as the one we just discussed, except it's for the year ended 12/31/02; correct?

A. That's correct.

Q. Would you look under Mr. Morgenstern's column and tell us how much he was paid in the year 12/31/02?

A. $678,933.

Q. All right. Now, that's a different number than he was paid in '04; correct?

A. That's correct.

Q. How did that come about?

A. In '01, which I don't remember if it was his first or second year of deferred comp, he – limits did kick in, which made his deferred comp go down. So the 678, the excess of $40,000 or so, is from the prior year.

[92]

Q. All right. So let's make sure I understand. So for the year '01, the limits kicked in such that he did not receive his full payment for that amount of money; correct?

A. That's correct.

Q. And that was because there weren't sufficient revenues in the year '01 to pay all the monies owed under the deferred plan according to the formulas; correct?

A. That's correct.

Q. But in the year '02 there were more than enough revenues not only to pay what he was owed on an annual basis, but also what he was owed from the prior years, correct, or the prior year?

A. That's correct. The plan is designed so that if limits kick in, the amount unpaid is eligible to be paid if the limits go back up.

Q. All right. So that with sufficient revenues he would – the next year, in '02, he not only made his set amount but what was owed to him from the prior year; correct?

A. Essentially he was restored to where he would have been.

* * * * *

EXHIBIT E-4

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF BURTON W. RUDER

September 26, 2005

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* * * * *

[61]

* * * * *

BY MR. BRICKMAN:

Q. . . . With regard to Mr. Morgenstern, do you know if he receives any money from Harris Associates at the present time?

A. Yes.

Q. And what does he receive money for?

A. He receives money for his deferred compensation when he left the firm.

Q. And when did you come to learn that he received money as deferred compensation from Harris Associates?

A. Well, some time ago.

Q. A year ago? Five years ago?

A. It had to be after 2000. So in the last three or four years.

* * * * *

[64]

* * * * *

BY MR. BRICKMAN:

Q. Mr. Morgenstern, you learned, has a deferred compensation plan; correct?

A. Correct.

[65]

Q. He receives a certain amount of money each year based on a formula that you just recently learned about; correct.

A. Correct.

Q. Are you aware or were you aware prior to today that if revenues at Harris Associates go down, that he might not receive some or all of that deferred compensation?

* * * * *

THE WITNESS: I'm not sure I understand that question.

BY MR. BRICKMAN:

Q. Okay. Let's try again.

Are you aware that his deferred compensation payments –

A. Right.

Q. (Continuing) – may be impacted, reduced, or wiped out if revenues at Harris Associates decrease?

MS. FELICELLO: Objection.

[66]

THE WITNESS: No.

* * * * *

EXHIBIT E-7

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF ALLAN J. REICH

November 11, 2005

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* * * * *

[38]

* * * * *

BY MR. BRICKMAN:

Q. . . . What is your understanding then of the deferred compensation he was receiving?

A. That a certain portion of his partnership income would be paid out over a period of time after his retirement.

Q. Do you know how it was calculated?

A. I don't recollect.

* * * * *

EXHIBIT E-8

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF THOMAS H. HAYDEN

September 12, 2005

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* * * * *

[165]

* * * * *

Q. . . . As you told me earlier, you are an independent director, correct?

A. Yes, sir.

Q. What is the significance of you being independent?

A. I'm not understanding what you're asking.

Q. Why is it – is it important that you be an independent director as opposed to some other type or non-independent?

A. Well, it's important that a certain number of directors be independent.

Q. And why is that important?

A. Well, it's important because the law or the SEC requires it, but, in addition, to represent the best interests of the shareholders.

Q. And what does it take for you to be independent, if you know?

A. It takes me not having any financial or other benefits coming from the Adviser.

Q. Now, as I understand, there are times [166] when the independent directors meet without any of the interested directors or those that receive some financial benefit from the Adviser, is that correct?

A. That's correct.

Q. And why do y'all have meetings like that, if you know, where just the independent directors meet?

A. Because there are sometimes things we would like to discuss without the interested directors present.

Q. Like what?

A. Many number of different things. Contract renewal for one.

Q. Okay.

And why do you need to discuss contract renewal amongst just the independent directors and not with the interested directors?

A. Because they're interested, and they have some ability to benefit from whatever the contract might be, I suppose.

Q. Okay.

So for that reason, you don't want your discussions swayed one way or the other by their [167] self interest?

A. It's appropriate that the independent trustees meet alone.

Q. Why is it appropriate?

A. Because if we're going to conduct arm's length negotiations, we need to be able to meet and discuss issues among ourselves without having present people who are employed by the Adviser, albeit those people may as well sit on the Board.

Q. Is it important for the shareholders to know that they have truly independent trustees representing them?

A. I believe that's important.

* * * * *

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed Sept. 12, 2006]

DEFENDANT HARRIS ASSOCIATES, L.P.'S LOCAL RULE 56.1 STATEMENT OF UNDISPUTED FACTS

1. The Plaintiffs bring this action derivatively on behalf of three of the six mutual funds for which Defendant Harris Associates, L.P. ("Harris") serves as investment adviser – the Oakmark Fund, the Oakmark Equity and Income Fund and the Oakmark Global Fund (collectively, the "Funds"). *See* Am. Compl., dated May 11, 2005 ("Compl."), ¶ 1.

2. Plaintiffs bring this action pursuant to Section 36(b) of the Investment Company Act of 1940 ("ICA"). *See* Compl. ¶¶ 1-2.

3. Harris has its principal place of business in Chicago, Illinois. All of its employees are employed in Illinois. The Funds at issue in this action are sold nationwide, including to citizens of Illinois. *See* Responses to Information Request of the Management Contracts Committee, dated May 2004 ("Mgmt.

Contracts Request"), attached as Ex. 1 to the Declaration of Brian R. Blais ("Blais Decl."), at HA 0000238.

4. Venue is proper in the Northern District of Illinois. *See* Compl. at ¶ 3; Order, Case No. 04-04184-CV-C-NKL (W.D. Mo. Dec. 21, 2004), at 2 (". . . Plaintiffs . . . do not dispute that this action could have been brought in the Northern District of Illinois . . . .") (transferring this case to Northern District of Illinois pursuant to 28 U.S.C. § 1404(a)).

5. Each of the funds in The Oakmark Family of Funds is a series of Harris Associates Investment Trust, a Massachusetts business trust ("HAIT"), which is governed by a board of trustees. *See* The Oakmark Family of Funds Statement of Additional Information, dated Jan. 31, 2004 ("2004 SAI"), attached as Ex. 2 to Blais Decl., at HA 0112518 – HA 0112519, HA 0112540 – HA 0112546.

6. Each Oakmark fund is a registered investment company under the ICA, 15 U.S.C. § 80a-1 *et seq.*, and Harris serves as investment adviser pursuant to a separate advisory agreement with each Fund. *See* 2004 SAI at HA 0112519, HA 0112536 (Ex. 2).

7. Plaintiffs Jerry N. Jones and Mary Frances Jones are shareholders of the Oakmark Equity and Income Fund and the Oakmark Global Fund. Plaintiff Arline Winnerman is a shareholder of the Oakmark Fund. *See* Compl. ¶¶ 19-20.

8. For its service as investment adviser, Harris receives a fee from each Fund, calculated as a percentage of that Fund's net assets at the end of the preceding month. *See* 2004 SAI at HA 0112536 (Ex. 2).

9. The fee schedule for the Funds is set forth as part of the advisory contract for each Fund and is negotiated and approved each year by the trustees. *See* 2004 SAI at HA 0112536-HA 0112537 (Ex. 2).

10. The fee schedule for each of the Funds features "breakpoints," *i.e.*, asset levels at which the fee declines. *See* 2004 SAI at HA 0112536 – HA 0112537 (Ex. 2); The Oakmark Family of Funds Statement of Additional Information, dated Jan. 28, 2005 ("2005 SAI"), attached as Ex. 3 to Blais Decl., at 17-20.

11. In recent years, the annual contract renewal process resulted in the initiation of additional breakpoints in the fee schedules of the Funds. *See* Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated Aug. 25, 2003 ("August 25, 2003 Committee Minutes"), attached as part of Ex. 5 to Blais Decl., at HA 0002884 – HA 0002890.

12. The following table summarizes the fee schedule for each of the Funds, as negotiated and approved by the trustees, including the additional breakpoints negotiated and approved by the trustees during 2003 and 2004:

The Oakmark Fund	Equity & Income Fund
First $2.0 billion under mgmt: 1.00%	First $5.0 billion under mgmt: 0.75%
Next $1.0 billion under mgmt: 0.90%	Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2003)*
Next $2.0 billion under mgmt: 0.80%	Next $2.5 billion under mgmt: 0.675% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.75%	Next $2.5 billion under mgmt: 0.65% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2004)*	
Net assets over $10 billion 0.65% *(New breakpoint as of 11/1/2004)*	Net assets in excess of $12.5 billion: 0.60% *(New breakpoint as of 11/1/2004)*

Global Fund
First $2.0 billion under mgmt: 1.00%
Next $2.0 billion under mgmt: 0.95% *(New breakpoint as of 11/1/2003)*
Net assets in excess of $4 billion. 0.90% *(New breakpoint as of 11/1/2003)*

See 2004 SAI at HA 0112536 – HA 0112537 (Ex. 2); 2005 SAI at 18 (Ex. 3).

13. The applicable advisory fees are fully disclosed to shareholders in the Funds' Statement of Additional Information, and the shareholders are able to redeem their shares at any time should they prefer to invest in a fund with lower fees. *See* 2004 SAI at HA 0112536 – HA 0112537, HA 0112548 – HA 0112550 (Ex. 2); 2005 SAI at 18, 30-33 (Ex. 3); Prospectus for the Oakmark Family of Funds, dated Jan. 29, 2003 ("2003 Prospectus"), attached as Ex. 7 to Blais Decl., at HA 0051837 – HA 0051843; Prospectus for the Oakmark Family of Funds, dated Jan. 31, 2004 ("2004 Prospectus"), attached as Ex. 8 to Blais Decl., at HA 0005634 – HA 0005647.

14. The annual process of negotiating and approving Harris' advisory contract and fees pursuant to Section 15(c) of the ICA spans several months and involves multiple meetings between Harris and certain of the trustees. *See* Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated May 1, 2002 ("May 1, 2002 Committee Minutes"), at HA 0005315 – HA 0005318; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated May 14, 2002 ("May 14, 2002

Committee Minutes"), at HA 0005319 – HA 0005322; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated June 25, 2002 ("June 25, 2002 Committee Minutes"), at HA 0005056 – HA 0005059; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated July 12, 2002 ("July 12, 2002 Committee Minutes"), at HA 0005061 – HA 0005066; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated Sept. 11, 2002 ("September 11, 2002 Committee Minutes"), at HA 0005067 – HA 0005069; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated Apr. 16, 2003 ("April 16, 2003 Committee Minutes"), at HA 0002844 – HA 0002849; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated June 6, 2003 ("June 6, 2003 Committee Minutes"), at HA 0002850 – HA 0002856; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated June 24, 2003 ("June 24, 2003 Committee Minutes"), at HA 0002857 – HA 0002861; August 25, 2003 Committee Minutes at HA 0002884 – HA 0002890; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated Feb. 17, 2004 ("February 17, 2004 Committee Minutes"), at HA 0002927 – HA 0002933; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated May 25, 2004 ("May 25, 2004 Committee Minutes"), at HA 0002951 – HA 0002957; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated June 2, 2004 ("June 2, 2004 Committee Minutes"), at HA 0002958 – HA 0002966; Min-

utes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated July 20, 2004 ("July 20, 2004 Committee Minutes"), at HA 0002967 – HA 0002974. Minutes of the Meetings of the Committee on Management Contracts during 2002 are collected as Ex. 4 to Blais Decl. Minutes of the Meetings of the Committee on Management Contracts during 2003 are collected as Ex. 5 to Blais Decl. Minutes of the Meetings of the Committee on Management Contracts during 2004 are collected as Ex. 6 to Blais Decl.

15. Much of the trustees' information-gathering and analysis undertaken pursuant to Section 15(c) of the ICA is completed by a Management Contracts Committee of the board, which then makes a recommendation to the full board for consideration. The Management Contracts Committee met five times over the course of five months in 2002, four times over the course of five months in 2003, and four times over the course of the six months prior to the filing of the complaint in this action in August 2004. *See* sources cited in ¶ 14, *supra*.

16. The trustees are advised throughout this process by independent, outside counsel from the firm of Bell Boyd & Lloyd. *See* sources cited in ¶ 14, *supra*.

17. Each year, Harris provides to the trustees at their request information on a variety of topics: the services provided by Harris to the Funds in exchange for the fees; the Harris personnel providing those services; the investment performance of the Funds; the profitability of the advisory contracts to Harris, including detailed information about Harris expenses; certain transactions between the Funds and entities affiliated with Harris (*e.g.*, Harris' affiliated broker); benefits accruing to Harris in addition to fees (*e.g.*,

use of "soft dollars" to offset the cost of research services); and compliance information, including information about the best execution of portfolio transactions for each Fund, allocation of purchase and sale transactions among broker-dealers and compliance with the Funds' investment restrictions. *See* Mgmt. Contracts Request, at HA 0000213 – 0000217 (Ex. 1); Dep. Tr. of Thomas H. Hayden ("Hayden Dep."), attached as Ex. 9 to Blais Decl., at 48-52.

18. The trustees also commission a third-party industry consultant known as Lipper to provide certain requested data. These materials include comparisons of the Oakmark Funds' investment performance, fees, and profitability to those of a peer group of the Funds' competitors. *See* May 14, 2002 Committee Minutes at HA 0005319 – HA 0005320 (Ex. 4); June 25, 2002 Committee Minutes at HA 0005056 – HA 0005057 (Ex. 4); April 16, 2003 Committee Minutes at HA 0002844 – HA 0002846 (Ex. 5); June 6, 2003 Committee Minutes at HA 0002850 – HA 0002853 (Ex. 5); May 25, 2004 Committee Minutes at HA 0002951 – HA 0002957 (Ex. 6); Confidential Report to the Trustees prepared by Lipper, Inc., dated June 25, 2002 ("2002 Lipper Report"), attached as Ex. 10 to Blais Decl., at HA 0082587 – HA 0082595; Confidential Report to the Trustees prepared by Lipper, Inc., dated June 6, 2003 ("2003 Lipper Report"), attached as Ex. 11 to Blais Decl., at HA 0081932 – HA 0081940; Confidential Report to the Trustees prepared by Lipper, Inc., dated May 25, 2004 ("2004 Lipper Report"), attached as Ex. 12 to Blais Decl., at HA 0001998 – HA 0002012; HA 0002095 – 0002110; HA 0002126 – HA 0002141; Confidential Report to the Trustees prepared by Lipper, Inc., dated May, 2004 ("2004 Supplemental Lipper Report"),

attached as Ex. 13 to Blais Decl., at HA 0089095 – HA 0089110. The investment performance figures in the Lipper materials are reported net of the advisers' fees. *See* 2004 Lipper Report at HA 0002225. The Lipper materials also present data on fees in isolation from the net performance figures. The 2004 Lipper report shows total expenses for each Fund as follows: Global Fund was 0.168% below the median for its peer group, the Equity and Income Fund was 0.025% above the median for its peer group and the Oakmark Fund was 0.174% above the median for its peer group. *See* 2004 Lipper report at HA 0002099, HA 0002130 (ex. 12); 2004 Supplemental Lipper Report at HA 0089099 (ex.13).

19. The portfolio management services provided by Harris to the Funds include, among others, research, stock selection, portfolio construction, monitoring compliance with investment restrictions, investor conference calls and proxy voting. *See* Mgmt. Contracts Request at HA 0000327 (Ex. 1).

20. In addition to providing portfolio management services, Harris provides office space, equipment and personnel to the Funds. *See* 2004 SAI at HA 0112536 (Ex. 2).

21. Harris also provides additional administrative services to the Funds, such as shareholder communications, including the preparation and distribution of quarterly reports and prospectuses; oversight of third-party service providers, including the transfer agent, custodian and other intermediaries; trustee support, including trustee education and the preparation of materials for board meetings; and risk management. *See* Mgmt. Contracts Request at HA 0000327 – HA 0000331 (Ex. 1).

22. Harris also serves as investment adviser to a variety of non-mutual fund accounts, including accounts of institutional investors and high net worth individuals. Harris also contracts to provide sub-advisory services to various funds for which other investment advisers act as the primary adviser. *See* Mgmt. Contracts Request at HA 0000223, HA 0000437 – HA 0000447 (Ex. 1).

23. Harris provides a spectrum of advisory services to these various non-mutual fund accounts and the fees charged to these accounts for the advisory services provided to them are generally different from the fees charged to the Funds. *See* sources cited in ¶ 22, *supra*.

24. At the request of the trustees, the 15(c) materials also describe which of the services provided by Harris to the Funds are *not* provided to Harris' non-mutual fund clients. *See* Mgmt. Contracts Request at HA 0000327 – HA 0000331, HA 0000437 – HA 0000447 (Ex. 1).

25. For the three year period ended March 31, 2004, the Oakmark Equity and Income Fund generated an average annual return of 12.49%, net of fees, the third best performance during that three year period of the 445 funds in its performance universe, as defined by Lipper, and above its benchmark, the Lipper Balanced Fund Index, which had an average annual return of 3.76%. For the five year period ending March 31, 2004, the Oakmark Equity and Income Fund's average annual net return of 13.91% was the single best performance result of any fund its performance universe, and above its benchmark figure of 3.11%. *See* 2004 Lipper Report at HA 0002107 (Ex. 12).

26. For the three year period ended March 31, 2004, the Oakmark Fund generated an average annual return of 6.22% net of fees, giving it a rank of 12 out of 307 funds in its Lipper performance universe, and placing it above its benchmark, the Lipper Large-Cap Value Index, which had an average annual return of 1.43%. For the five year period ended March 31, 2004, the fund's average annual net return was 5.29%, giving it a rank of 18 out of 224 funds in its performance universe, and above its benchmark figure of 1.22%. 2004 Supplemental Lipper Report at HA 0089107 (Ex. 13).

27. For the three year period ended March 31, 2004, the Oakmark Global Fund generated an average annual return of 22.36%, net of fees, the single best performance result of any of the 254 funds in its performance universe, as defined by Lipper. This return was above its benchmark, the Lipper Global Fund Index, which had an average annual return of 2.31%. For the four year period ending March 31, 2004, the Oakmark Global Fund's average annual net return of 20.24% was the single best performance result of any fund its performance universe, and above its benchmark, which had an average annual loss of 4.8%. *See* 2004 Lipper Report at HA 0002138 (Ex. 12).

28. *Kiplinger's* magazine selected the Oakmark family as one of the ten best no-load fund families on the market in August 2003 and named the Oakmark Fund as one of 25 "all-star" stock funds in May 2004. *See* Steven T. Goldberg, *Who Runs the Best Funds?*, *Kiplinger's*, Aug. 2003, attached as Ex. 14 to Blais Decl., at 32-37; Steven T. Goldberg, *The 25 Best Funds*, *Kiplinger's*, May 2004, attached as Ex. 15 to Blais Decl., at 36, 39-40, 50.

29. *Barron's* and *Money* magazine both named the Oakmark Fund and the Oakmark Equity and Income Fund to their list of the world's top 100 mutual funds in August 2003. *See* Letter from Robert Safian to Kelly Arnold, dated Aug. 11, 2003, attached as Ex. 16 to Blais Decl.; Christopher C. Williams, *The Top 100: A Breed Apart, Barron's Online*, Aug. 4, 2003 *available at* http://online.wsj.com/barrons/article_print/0,,SB105977734239724000,00.html, attached as Ex. 17 to Blais Decl.

30. Fund industry analyst Lipper placed both the Oakmark Global Fund and the Oakmark Equity and Income Fund in its list of 35 funds that "provided consistently superior returns in their respective groups." *See* Reuters, *Fund Firms Receive Lipper Awards*, Mar. 16, 2004, *available at* http://biz.yahoo.com/rf/040316/finance_lipper_awards_1.html, attached as Ex. 18 to Blais Decl.

31. In a survey analyzing "which fund companies put investors first," *Money* magazine gave the Oakmark family "top marks" for having "especially laudable or innovative policies." *See* Jason Zweig, Adrienne Carter and Cybele Weisser, *The Good, The Bad and The Ugly*, Money, Feb. 2004, attached as Ex. 19 to Blais Decl.

32. Fund industry analyst Morningstar selected William Nygren, the portfolio manager of the Oakmark Fund, as the industry's "Domestic Stock Manager of the Year" for 2001. *See* Russel Kinnel, *Morningstar Fund Managers of the Year 2001, Morningstar.com*, Jan. 4, 2002, *available at* http://news.morningstar.com/doc/article/0,1,11729,00.html?hSection=fromAnalysts, attached as Ex. 20 to Blais Decl.

33. A March 2004 survey by *SmartMoney* magazine named William Nygren as one of the 11 top fund managers out of 11,000 under consideration. *See* Evelyn E. Twitchell, *Great Managers for All Seasons*, *SmartMoney*, March 2004, attached as Ex. 21 to Blais Decl., at 78-83.

34. An August 2004 survey by *Barron's* named the managers of Oakmark Equity and Income Fund (Clyde McGregor) and Oakmark Global Fund (Michael Welsh) as the top managers in the industry for their respective investment objective categories. *See* Christopher C. Williams, *Now Starring . . .*, *Barron's*, August 16, 2004, attached as Ex. 22 to Blais Decl.

35. The Funds' investment advisory contracts with Harris expressly authorize Harris to utilize its affiliated broker to execute the Funds' transactions. *See* 2004 SAI at HA 0112552– HA 0112553 (Ex. 2).

Respectfully submitted,

HARRIS ASSOCIATES, L.P.

BY: /s/ BRIAN R. BLAIS

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Admitted pro hac vice

Dated: September 12, 2006

EXHIBIT 1

Harris Associates Investment Trust

Management Contracts Committee
Responses to Information Request
May 2004

Two North LaSalle Street
Chicago, Illinois 60602-3790
312.621.0600

THOMAS H. HAYDEN
1115 Chestnut Avenue
Wilmette, Illinois 60091

March 31, 2004

Mr. John Raitt
Harris Associates L.P.
Two North LaSalle Street, #500
Chicago, Illinois 60602

Harris Associates Investment Trust

Dear John:

At a meeting of the Board of Trustees of Harris Associates Investment Trust (the "Trust") to be held later this year, the Board will consider whether to continue the Investment Advisory Agreements between the Trust and Harriis Associates L.P. ("HALP") and the distribution agreement with Harris Associates Securities L.P. Those agreements are referred to as "Agreements". Each series of the Trust is called a "Fund," and all series of the Trust are collectively called the "Funds" in this letter. References to HALP throughout this letter are meant to include, where appropriate, HALP's affiliates.

To facilitate our review of the Agreements, we would appreciate your furnishing the following information pertaining to HALP:

A. Description of HALP's Business

1. Organizational chart
2. Description of any significant changes that have occurred or are anticipated in the

future in the various principal activities in which HALP is involved, aside from its services to the Funds.

Please discuss any changes that may reasonably be viewed to bear on HALP's performance of services to any Fund or otherwise to have an effect on any Fund.

3. If applicable, description of any advantages that might be available to any Fund due to HALP's involvement in other activities.
4. HALP's balance sheet as of the end of its last fiscal year.
5. Description of any litigation or regulatory proceeding involving HALP or its affiliates that might affect any Fund.
6. A copy of HALP's current Form ADV (parts I and II).

B. HALP's Personnel and Operations

1. Organizational chart showing the professional personnel (e.g., executives, lawyers, economists, statisticians, investment analysts and portfolio managers, etc.) who perform services for any Fund.

   Describe any significant changes that have taken place since December 31, 2002 or that are anticipated in the future. Note should be made of recent or anticipated hirings, departures, or transfers of professional persons, particularly of senior personnel and the reason for such actions. With respect to new or anticipated personnel, include a summary of their education, experience and various responsibilities.

With respect to all personnel performing services for a Fund, identify those responsible for Fund matters and for compliance with the Fund's investment objectives. Estimate the percent of each person's time spent on Fund activities.

2. Description of the methodology for compensation of portfolio managers and analysts.
3. Information as to the number of funds and the number of non-fund accounts managed or co-managed by the manager(s) of each Fund, and the total assets in each of those two categories of accounts.
4. Information as to the approximate value of the shareholdings in each Fund beneficially owned in the aggregate by (1) portfolio managers, (2) other officers of the Trust or officers or directors of HALP, (3) other employees of HALP and (4) the independent trustees of the Trust.

C. Services

1. Description of the advisory, administrative and other material services rendered by HALP for each Fund, emphasizing any significant changes in those services since December 31, 2002.
2. Discussion of any anticipated change in any Fund's needs for services and description of any new services that HALP contemplates rendering to any Fund in the future and the related costs.
3. Analysis of the investment performance of each Fund and comparison with the performance of comparable open-end funds and indexes.

4. Analysis of each Fund's expenses and comparison with expenses of comparable open-end funds.
5. Any other information that you believe is relevant in evaluating the services performed by HALP in accordance with the Agreements.

D. Compensation

1. Description of the current advisory fees paid by the Funds to HALP and any proposals for changes in the terms or amount of compensation to be paid under each Agreement. Description of any other fees paid by any Fund to HALP.

   Disclose the actual fees paid to HALP by the Trust on an annual basis during each of the past three years.
2. Comparison of HALP's management fees for each Fund with fees charged by HALP to any other large institutional or other clients with comparable investment objectives, if applicable.
3. Analysis of the profitability to HALP (including Harris Associates Securities LP and CDC IXIS Asset Management Services, Inc.) of its relationship with each Fund, including expenses relative to its services to each Fund (advisory services alone and consolidated with all services provided by HALP and its affiliates to the Fund) for each Fund, noting any significant changes during the past two years.

4. A table showing annual expenses of HALP related to each Fund in the Trust for the last three years.

   Explain the reasons for any material increases or decreases in HALP's expenses.

5. Information regarding other open-end funds with investment objectives and asset levels comparable to each Fund with respect to advisory fees, including: (a) the manner by which their fees are computed, including fee schedules and breakpoints; (b) their expenses; and (c) their overall expense ratios.

   Comment on any material differences in expense items.

6. Information regarding each intermediary relationship by Fund and in total showing (a) value of shares held by that intermediary, (b) fees and rate of fees paid by the Fund to that intermediary last year for transfer agency/shareholder servicing services, (c) fees and rate of fees paid by the adviser to that intermediary last year (excluding fees paid or reimbursed by the Fund).

7. Discussion of any additional factors that should be taken into account in evaluating the fees paid by the Funds to HALP.

8. Discussion of whether HALP believes it has experienced, or in the future is likely to experience, economies of scale in connection with the operation of any Fund.

9. Evaluation of any benefits that accrue to HALP because of its relationship with any Fund (other than fees paid by the Fund), and

benefits that accrue to each Fund because of its relationship with HALP.

Please identify any brokers or dealers that provided research or other products or services to HALP in consideration of brokerage commissions paid by HALP clients and describe the services received by HALP from each, the benefits derived from those services, and the amount of business transacted with each by the Funds and by all other clients of HALP in the aggregate.

E. Compliance

1. Description of HALP's compliance programs with respect to the Funds, emphasizing federal and state securities laws, state laws applicable to business trusts and corporations, and Subchapter M of the Internal Revenue Code.
2. Description of the results of any examinations of HALP by the SEC, NASD, any state securities authority or independent auditors since December 31, 2001.
3. Description of the method of allocating acquisitions of portfolio securities between each Fund and other portfolios or accounts over which HALP has discretionary authority, and state whether each Fund is fairly served by that policy.

   Describe any conflicts that HALP has experienced or anticipates it may experience in managing each Fund's portfolio because it also has discretionary authority over other portfolios.

4. Discussion of HALP's experience since December 31, 2002 in obtaining the most favorable execution of portfolio transactions for each Fund, stating the average per share costs of brokerage to each Fund.
5. Description of HALP's policies and procedures regarding allocation of purchase and sale transactions among broker-dealers.
6. Description of HALP's practices in monitoring compliance with the Funds' investment restrictions and in reviewing portfolio valuation.
7. Report on analysis of the number and types of any complaint telephone calls or letters received by HALP from the Funds' shareholders and copies of any significant letters.
8. Description of HALP's insurance coverage as it relates to HALP's activities provided to the Funds.
9. Description of any significant violations of HALP's Code of Ethics since December 31, 2002.

F. Other

1. Any ideas HALP may have for the future growth, efficient operation or different services for any Fund that may be relevant to the Trustees' consideration.
2. Discussion of the particular expertise of HALP not readily available from competing fund managers.
3. Discussion of any other facts and information not requested above that may assist the board members in evaluating HALP's services or that may otherwise be relevant.

Please submit your responses in order of and keyed to each of the items listed above.

In order to allow adequate time for review and analysis of the information requested, please send a copy to me of your responses to these items no later than May 12, 2004.

Sincerely,

/s/ THOMAS H. HAYDEN

Thomas H. Hayden

Copies to: Trustees of Harris Associates Investment Trust

Cameron S. Avery

HARRIS ASSOCIATES INVESTMENT TRUST

Item A.3

If applicable, description of any advantages that might be available to any Fund due to HALP's involvement in other activities.

Response

In addition to The Oakmark Family of Funds, HALP serves as the advisor to numerous pension, foundation, endowment, and high net worth clients. We believe the diversity of our client base provides HALP with revenue and operational stability. This allows the firm to attract and retain a deeper pool of investment talent.

HARRIS ASSOCIATES INVESTMENT TRUST

Item C.1

Description of the advisory, administrative and other material services rendered by HALP for each Fund, emphasizing any significant changes in those services since December 31, 2002.

Response

The sponsor of a mutual fund has numerous responsibilities and fulfills many roles. We have attempted to classify these roles and categorize the services accordingly.

Investment Advisory Services

- Research
- Stock selection
- Portfolio construction
- Testing and monitoring compliance with investment restrictions
- Performance and related attribution calculations
- Investor conference calls
- Proxy voting

Administrative Services

I. Post Effective Amendment

- Manage the preparation of post-effective amendments
- Coordinate review by fund counsel, auditors, custodian and management
- Coordinate the calculation of expense tables and provision of other supporting financial information
- Coordinate EDGAR filing process to SEC

- Coordinate printing and distribution of prospectus and SAI

II. Shareholder Communications

A. Manage the preparation of annual, semi-annual and quarterly reports to shareholders

- Draft and manage production calendar
- Conduct Deloitte annual audit and semi annual review
- Coordinate review by management, custodian, and fund counsel
- Manage Sarbanes-Oxley certification and disclosure control procedures
- Coordinate EDGAR filings to SEC, including N-SAR and N-CSR filings
- Coordinate printing and distribution of the reports to shareholders
- Manage inventory

B. Fund applications, forms and other Fund information

- Draft and update applications and forms
- Coordinate review by transfer agent and fund counsel
- Coordinate printing and distribution
- Manage inventory
- Fund holdings, performance information, etc.
  - Prepare and collect Fund information for dissemination to service providers, industry associations, shareholders and potential investors
  - Disseminate Fund information via various media

III. Service Provider Oversight

A. Transfer Agent Operations

- Manage contract negotiations process
- Oversee transfer agent operations
- Oversee monitoring of transaction processing to identify short-term traders
- Manage process of restricting identified short-term traders
- Oversee transfer agent AML/CIP programs
  - Review monthly tracking reports
  - Confer and decide on sufficient investor identification
- Compile transaction information and negotiate agreements with brokers that process transactions through the Depository Trust Clearing Corporation
- Assist Adviser's clients and employees in investing in the Funds and initiate processing of transactions

B. Custodian Operations

- Manage contract negotiations process
- Oversee custodian operations
- Oversee collateralization of repurchase agreements and securities on loan
- Coordinate allocation, approval, and payment of Fund expenses
- Manage the Funds' line of credit process
- Manage the Funds' "distribution" process
  - Draft annual "distributions" resolution for trustee approval
  - Prepare materials for trustee meeting to obtain approval of methodology

- Prepare estimates for distribution throughout the year for early management of outcome
- Coordinate distributions calculation process
- Manage communication of distributions information to shareholders

• Oversee portfolio valuation
• Oversee foreign subcustodian relationships
• Determine taxation of sophisticated transactions such as options, short sales, or arbitrage strategies
• Direct the preparation of Fund income tax returns
• Manage the shareholder tax information process
  - Coordinate the calculation of tax information for IRS Forms 1099 DIV and 1099B
  - Prepare the information for Shareholder Tax Information sheet which includes information on dividends from U.S. Government Obligations, value of U.S. Government Obligations in each Fund, character of capital gains, qualified dividend income, and foreign tax credit information
  - Coordinate the production and dissemination of the Tax Information sheet

C. Printing Operations
• Manage the contract negotiations process with outside vendors

- Oversee and coordinate printing of all fund materials, including prospectuses, shareholder reports, statements of additional information, all IRA booklets, Fund forms, tax information sheets, confirmation statements, and quarterly account statements

D. Intermediaries

- Manage the contract negotiations process
  - Coordinate review of contracts among intermediary, management and Fund counsel
  - Coordinate implementation of share transaction processing with intermediary and CIS
- Manage the allocation, approval and payment of intermediary servicing fees

IV. Trustee Support

A. Board and Committee Meetings

- Coordinate the preparation of agendas, resolutions and supporting materials for packets for board and committee meetings
- Collect and assemble materials for board and committee packets, which include reports on compliance matters, quarterly financial information, affiliated brokerage reports, summary performance information and required annual review and approval materials and distribute to trustees
- Attend board and committee meetings

B. Trustee Compensation

- Accrue, pay and track trustee compensation
- Administer trustee deferred compensation plan
- Report on compensation for regulatory filings

C. Trustee Information and Education

- Design and maintain trustee website
- Assist Fund counsel in maintaining trustee education calendar
- Coordinate or arrange for trustee attendance at educational events

V. Risk Management

A. Disaster Recovery Plan

- Manage design and testing of disaster recovery plan
- Design and maintain back up recovery capabilities
  - Maintain physical plant in Lisle, IL
  - Design and maintain systems for backing up data
  - Purchase/manage/monitor solutions for both real time replication and daily tape back up

B. Audits

- Prepare responses and compile documents in response to SEC and NASD audits
- Assist CDC IXIS' auditing process

C. Insurance

- Manage the procurement of Errors and Omissions ("E&O") insurance policies

- Manage negotiations with the insurance broker to maintain quality policies at reasonable prices
- Direct the process for obtaining trustee approval of E&O policies and allocation agreements
- Coordinate the process of premium allocation between the Funds and other parties

• Manage procurement process of Funds' Fidelity Bond
- Direct the procurement of fidelity bond through insurance broker
- Coordinate obtaining trustee approval of fidelity bond
- Prepare insurance documents and file with the SEC

D. State Filings
• Prepare and file Massachusetts business trust filings
• Oversee outside vendor's state registrations and filings regarding Fund share sales (Blue Sky)

E. Codes of Ethics and Compliance
• Oversee and enforce Codes of Ethics to insure compliance
• Design and implement compliance policies and procedures (see also Item E.1)

Other Material Services

I. Trading

- Execution of portfolio transactions
- Manage affiliated portfolio transactions' reporting process
- Manage soft dollar transactions' reporting process
- Assist portfolio managers in identifying trading opportunities
- Manage "best execution" reporting process

II. Marketing

- Design, produce and distribute marketing materials
- Coordinate compliance review of marketing materials by management and Fund counsel
- Manage SEC and NASD filing process
- Design and maintain the Oakmark Funds' website

HARRIS ASSOCIATES INVESTMENT TRUST

Item D.2 (Revised 7/15/04)

Comparison of HALP's management fees for each Fund with fees charged by HALP to any other large institutional or other clients with comparable investment objectives, if applicable.

Observations

HALP believes that it is important to distinguish between the nature of services performed for separate accounts or sub-advised funds and those performed for the Oakmark Family of Funds. Management of a mutual fund involves far more comprehensive and substantive duties than the management of sub-advised funds or separate accounts.

To illustrate this point, please refer to the list of services HALP provides in Item C.1. These services are described under the categories of Investment Management, Administrative and Other. Note that nearly all of the duties described in the Administrative services section (3+pages in total) are exclusive to the Oakmark Family as sponsor of the Funds.

Sub-advised funds and separate accounts engage HALP for investment management services only. Sub-advised mutual funds typically ask HALP to assist them in meeting certain compliance-oriented administrative obligations. However this is most often accomplished through quarterly questionnaires and annual due diligence visits. The due diligence effort is only a portion of their total responsibilities, and the total management fees are broken out accordingly.

Response

Included at this tab are three documents. The first document summarizes all relevant products and fee structures and reflects whether the strategy is open to new clients. To facilitate 'apples to apples' comparisons, we have included the effective management fee paid by shareholders and the total expense ratios of the sub-advised funds. This allows one to compare that fund's total management fee and expense ratio to its respective Oakmark Family Fund. The second document lists all available (i.e. open to new clients) product offerings as of 6/30/04. The third document lists the services generally provided by HALP for each product category.

Large Cap Strategy Fee Information

Entity/Company	Open to New Clients?	Product/ Primary Portfolio Manager	Fee Schedule	HALP Effective Fee	Effective Mgmt Fee Paid by Others	Total Exp Ratio*	Inception	HALP AUM (6/30/04)
[redacted]								
Oakmark	Yes	The Oakmark Fund Bill Nygren	1.00% up to $2.0 B; .90% on the next $1.0 B; .80% on the next $2.0 B; .75% in excess of $5.0 B	0.88%	0.88%	1.07%	Aug-91	$6.3B
[redacted]								
CDC IXIS	Yes	CDC Star Advisers Fund Ed Loeb	.65% on first $50M .60% on next $50M .55% over $100M	0.58%	1.05%	1.99%	Jul-97	$205.7M
CDC IXIS	Yes	CDC Harris Associates Large Cap Value Fund Ed Loeb	.45% on first $250M .40% on next $250M .35% over $500M	0.43%	0.69%	1.64%	Jun-02	$357.6M
CDC IXIS	Yes	CDC Oakmark Large Cap Value Fund (Luxembourg) Floyd Bellman	.60% on first $200M .50% over $200M	0.61%	1.20%	1.70%	Jun-01	$311.4M
MetLife	Yes	Harris Oakmark Large Cap (Annuity) Floyd Bellman	.45% on first $100M .40% on next $400M .35% thereafter	0.41%	0.71%	0.83%	Nov-98	$456M
SunAmerica	Yes	Style Focused Large Cap Portfolio Fund Mike Mangan	.60% on first $75 M .55% on next $175 M .50% over $250 M	0.58%	1.00%	1.81%	Apr-02	$152.5M
SunAmerica	Yes	Style Select Focused Growth and Income Fund Mike Mangan	.75% on first $15M .45% on next $135M .40% over $150M	0.75%	1.00%	1.76	Aug-01	$144M
[redacted]								
Separate Account Fee Schedule .75% first $15M .45% over $10M minimum	Yes	Client #1 Ed Loeb/Mike Mangan	See attached for fee schedule	Performance fee	n/a	n/a	Aug-04	$258.9M
		Client #2 Ed Loeb/Mike Mangan	.50% on first $50M .45% on next $50M .40% on next $50M .35% on balance	0.45%	n/a	n/a	Oct-04	$160.3M
		Client #3 Ed Loeb/Mike Mangan	.58% on first $100M .40% on balance	0.56%	n/a	n/a	Dec-01	$120.5M
		Client #4 Ed Loeb/Mike Mangan	.675% on first $15M .405% on balance	0.47%	n/a	n/a	Jul-02	$61.8M
Limited Partnership	Yes	Large Cap L.P.	.75% on total assets ($1M minimum)	0.75%	n/a	n/a	Jul-03	$25.3M
[redacted]								
Limited Partnership	Yes	Large Cap L.P.	.75% on total assets ($1M minimum)	0.75%	0.75%	n/a	see above	see above

Fee information is obtained through Morningstar, fund prospectuses or quarterly reports and is as of the most recently reported period.
Harris Associates effective management fee is included in the "Total Mgmt Fee" received by the sponsor
*Total Expense Ratio before other expenses (12b-1 fees, sales loads, insurance costs)

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Concentrated Strategy Fee Information

Entity/Company	Open to New Clients?	Product/ Primary Portfolio Manager	Fee Schedule	HALP Effective Fee	Effective Mgmt Fee Paid by S/hers	Total Exp Ratio*	Inception	HALP AUM (6/30/04)
Mutual Fund								
Oakmark	No	The Oakmark Select Fund Bill Nygren	1.00% up to $1 B 0.95% on the next $500 M 0.90% on th next $500 M 0.85% on the next $500 M 0.80% on the next $2.5 B 0.75% in excess of $5 B	0.85%	0.85%	1.00%	Nov-98	$5.8B
Sub-Advised Partnerships								
CDC	Yes	CDC Harris Associates Focused Value Fund Floyd Bellman	.60% on first $1B .55% over $1B	0.60%	1.00%	1.69%	Mar-01	$345M
CDC	Yes	CDC Nvest Star Value Fund Bob Levy	.50% on first $100M .45% over $100M	0.50%	0.75%	1.81%	Feb-00	$36M
CDC	Yes	CDC Oakmark US Value Opportunities Fund (Luxembourg) Floyd Bellman	.75%	0.75%	1.50%	2.00%	Jun-01	$89M
Liman/Gregory	Yes	Master's Select Value Fund Bill Nygren	.65% on first $50M .60% on next $50M .55% over $100M	0.646%	1.10%	1.28%	Jun-00	$60.2M
MassMutual	No	MassMutual Focused Value Fund Bob Levy	.50% on first $100M .45% on next $400M .40% over $500M	0.44%	0.69%	1.30%	May-00	$704M
MetLife	Yes	Harris/Oakmark Focused Value Fund (Annuity) Floyd Bellman	.45% on first $100M .40% on next $400M .35% over $500M	0.37%	0.75%	0.82%	May-00	$1.5B
Prudential	Yes	Strategic Partners Mid Cap Value Fund Bob Levy	.55% on first $1 B .45% on the balance	0.55%	0.90%	1.71%	Jun-02	$76.9M
Individual Accounts								
Separate Account Fee schedule 1.00% on the first $10M .50% thereafter $5m minimum	No	Client #1 Ed Loeb/Mike Mangan	.50% on first $50M .45% on the next $75M .40% on the next $75M .35% over $200M	0.44%	n/a	n/a	Aug-01	$200.6M
		Client #2 Bob Levy	.50% on first $50M .45% on the next $75M .40% on balance	0.45%	n/a	n/a	Feb-98	$179.6M
		Client #3 Bob Levy/Ed Loeb	.90% on first $10M .45% on balance	0.51%	n/a	n/a	Jan-03	$70.5M
High Net Worth Individuals								
Separate Account	Yes	Available @ $3M minimum	1.00% first $10M .75% over	n/a	n/a	n/a	n/a	n/a
Goldman	No	Goldman Sachs	0.80%	0.80%	0.80%	wrap program	Jun-03	$730.7M

Fee information is obtained through Morningstar, fund prospectuses or quarterly reports and is as of the most recently reported period.
Harris Associates effective management fee is included in the "Total Mgmt Fee" received by the sponsor.
*Total Expense Ratio before other expenses (12b-1 fees, sales loads, insurance costs)

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Balanced Strategy Fee Information

Entity/Company	Open to New Clients?	Product/ Primary Portfolio Manager	Fee Schedule	HALP Effective Fee	Effective Mgmt Fee Paid by Shrhrs	Total Exp Ratio	Inception	HALP AUM (6/30/04)
[redacted]								
Oakmark	Yes (existing shareholders, direct investors, and retirement plans)	The Oakmark Equity and Income Fund Clyde McGregor	.75% on first $5B .70% on next $2.5B .675% on next $2.5B .65% in excess of $10B	0.73%	0.73%	0.92%	Nov-95	$7.7B
[redacted]								
Separate Account Fee Schedule (Large Cap Balanced only) .75% on the first $15M .45% thereafter $50M minimum	Yes	Client #1 (Large Cap) Ed Loeb/Mike Mangan	.35% on first $100M .30% on next $400M .25% on balance	0.31%	n/a	n/a	Feb-02	$429M
		Client #2 Ed Loeb/Bob Levy	.50% on first $50M .45% on next $25M .40% on balance	0.42%	n/a	n/a	Jan-95	$270.9M
[redacted]								
Separate Account	Yes	$3M minimum	1.00% on the first $10M, .75% thereafter	n/a	n/a	n/a		n/a

Fee information is obtained through Morningstar, fund prospectuses or quarterly reports and is as of the most recently reported period.
Harris Associates effective management fee is included in the "Total Mgmt Fee" received by the sponsor.

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Small Cap Strategy Fee Information

Entity/Company	Open to New Clients?	Product/ Primary Portfolio Manager	Fee Schedule	HALP Effective Fee	Effective Mgmt Fee Paid by Sihers	Total Exp Ratio	Inception	HALP AUM (6/30/04)
[redacted]								
Oakmark	Yes	The Oakmark Small Cap Fund Jim Bonson	1.00%	1.00%	1.00%	1.26%	Nov-95	$388M
[redacted]								
Limited Partnership	Yes	Small Cap L.P.	.95% on total assets $1M minimum	0.95%	n/a	n/a	Apr-00	$12.8M
[redacted]								
Limited Partnership	Yes	Small Cap L.P.	95% on total assets $1M minimum	0.95%	n/a	n/a	see above	see above

Fee information is obtained through Morningstar, fund prospectuses or quarterly reports and is as of the most recently reported period.
Harris Associates effective management fee is included in the "Total Mgmt Fee" received by the sponsor.

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Global Strategy Fee Information

Entity/Company	Open to New Clients?	Product/ Primary Portfolio Manager	Fee Schedule	HALP Effective Fee	Effective Mgmt Fee Paid by Share	Total Exp Ratio*	Inception	HALP AUM (6/30/04)
[redacted]								
Oakmark	Yes (existing shareholders and direct investors)	The Oakmark Global Fund Michael Welsh/Clyde McGregor	1.00% on first $2B .95% on next $2B .90% in excess of $4B	1.00%	1.00%	1.23%	Aug-89	$1.4B
[redacted]								
Asahi	Yes	Asahi Global Fund (ex. Japan) Michael Welsh/Clyde McGregor	60%	0.60%	0.60%	1.00%	Mar-00	$139.5M
CDC	Yes	CDC Oakmark Global (Luxembourg) Michael Welsh/Clyde McGregor	80%	0.80%	1.50%	2.00%	Jun-01	$145M
[redacted]								
Separate Account Fee schedule 1.00% $75K minimum	Yes	Client #1 Michael Welsh/Clyde McGregor	.85% on first $25M .70% on next $25M .60% on next $50M .50% over $100M	0.81%	n/a	n/a	Feb-03	$166.8M
		Client #2 Michael Welsh/Clyde McGregor	.85% on first $25M .70% on next $25M .60% on next $50M .50% over $100M	0.65%	n/a	n/a	Jul-02	$121.4M
		Client #3 Michael Welsh/Clyde McGregor	.85% on first $25M .70% on next $25M .60% on next $50M .50% over $100M	0.81%	n/a	n/a	Jun-02	$35.9M

Fee information is obtained through Morningstar, fund prospectuses or quarterly reports and is as of the most recently reported period.
Harris Associates effective management fee is included in the "Total Mgmt Fee" received by the sponsor.
*Total Expense Ratio before other expenses (12b-1 fees, sales loads, insurance costs)

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Inte· ·tional Strategy Fee Information

Entity/Company	Open to New Clients?	Product/ Primary Portfolio Manager	Fee Schedule	HALP Effective Fee	Effective Mgmt Fee Paid by Shers	Total Exp Ratio*	Inception	HALP AUM (6/30/04)
[redacted]								
Oakmark	Yes (existing shareholders and direct investors)	The Oakmark International Fund David Herro	1.00% up to $2B .95% on the next $1B .85% in excess of $3 B	0.95%	0.95%	1.21%	Sep-92	$4.2B
[redacted]								
Charles Schwab	Yes	Schwab Int'l Market Masters Fund David Herro	.60% on first $125M .575% on next $125M .55% over $250M	0.60%	1.40%	1.65	Jun-02	$177.6M
Lipper/Gregory	Yes	Master's Select International Fund David Herro	0.65% on first $150M 0.55% thereafter	0.63%	1.10%	1.13%	Dec-97	$189.8M
MassMutual	Yes	MassMutual International Overseas Fund David Herro	.65% on first $50M .60% on next $50M .50% over $100M	0.58%	1.00%	1.95%	Jul-01	$247.8M
Met Life	Yes	Harris/Oakmark International Value Fund David Herro	.65% on first $25M .60% on next $225M .55% on next $250 M .50% over $500M	0.58%	0.85%	1.16%	Oct-01	$599.8M
SunAmerica	Yes	SunAmerica Focused International Fund Portfolio Davis Herro	.80% on first $75M .55% on next $175M .50% over $250M	0.60%	1.25%	1.94%	Nov-01	$70.6M
[redacted]								
Separate Account Fee schedule: .65% first $25M .70% next $25M .60% next $50M .50% next $100M negotiable thereafter $25M min.	No	Client #1 David Herro	.85% on first $25M .70% on next $25M .60% on next $50M .50% on next $100M .45% on next $100M .40% bal. avg. mkt. value	0.54%	0.54%	n/a	Mar-03	$405M
		Client #2 David Herro/Michael Welsh	.85% on first $25M .70% on next $25M .60% on next $50M .50% on the next $100M .45% on the next $100M .40% on balance	0.51%	0.51%	n/a	Aug-01	$397M
		Client #3 Michael Welsh	.85% on first $25M .70% on next $25M .60% on next $50M .50% on next $100M .45 % on balance	0.53%	0.53%	n/a	May-03	$349.9M
		Client #4 Michael Welsh	.85% on first $25M .70% on next $25M .60% on next $50M .50% on next $100M Over $200M negotiated	0.79%	0.79%	n/a	Dec-02	$49M
Limited Partnership		International L.P.	.95% on total assets ($1M minimum)	0.95%	0.95%	n/a	May-99	$1.03B
[redacted]								
Limited Partnership (closed to new investors)	No	International L.P.	.95% on total assets ($1M minimum)	0.95%	0.95%	n/a	see above	see above

Fee information is obtained through Morningstar, fund prospectuses or quarterly reports and is as of the most recently reported period.
Harris Associates effective management fee is included in the "Total Mgmt Fee" received by the sponsor
*Total Expense Ratio before other expenses (12b-1 fees, sales loads, insurance costs)

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Intl Small Cap Strategy Fee Information

Entity/Company	Open to New Clients?	Product/ Primary Portfolio Manager	Fee Schedule	HALP Effective Fee	Effective Mgmt Fee Paid by S/Hers	Total Exp Ratio	Inception	HALP AUM (6/30/04)
Mutual Funds								
Oakmark	No	The Oakmark Intl Small Cap Fund David Herro	1.25% up to $500M 1.10% in excess of $500 million	1.23%	1.23%	1.50%	Nov-95	$878M
Individual Accounts								
Separate Account Fee schedule: 1.00% up to $100M Negotiable thereafter $25M minimum	No	Client #1 David Herro	.85% on first $100M .65% on balance	0.74%	n/a	n/a	Jun-03	$234M
		Client #2 David Herro	0.85%	0.85%	n/a	n/a	Nov-01	$194.5M
		Client #3 David Herro	1.00%	1.00%	n/a	n/a	Jul-03	$51.6M

Fee information is obtained through Morningstar, fund prospectuses or quarterly reports and is as of the most recently reported period
Harris Associates effective management fee is included in the "Total Mgmt Fee" received by the sponsor.

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Harris Associates L.P.
Available Product Offerings
6/30/04

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Oakmark
- Oakmark Fund
- Oakmark Small Cap Fund
- Oakmark Equity and Income Fund (partial close)
- Oakmark International (partial close)
- Oakmark Global (partial close)

Institutional
- Large Cap Separate Account
- Large Cap Value L.P.
- Small Cap Separate Account
- Small Cap Value L.P.
- Large Cap Global Separate Account (partial close)*

Private Client Equity
- Concentrated
- Balanced
- Large Cap Value L.P.
- Small Cap Value L.P.

Sub-Advised (greater than $50M)
- AGF Harmony Overseas Fund
- AGF International RSP Fund
- AGF International Value Fund
- Asahi Global Value Fund
- CDC Harris Associates Focused Value Fund (US)
- CDC Harris Associates Large Cap Value Fund (US)
- CDC Harris Star Advisors Fund
- CDC Oakmark Global Fund (Luxembourg)
- CDC Oakmark Large Cap Value Fund (Luxembourg)
- CDC Oakmark US Value Opportunities Fund (Luxembourg)
- CDC Star Value Fund
- MassMutual Focused Value Fund
- MassMutual International Overseas Fund
- Masters' Select International Fund
- Masters' Select Value Fund
- MetLife/Harris Oakmark Focused Value Fund
- MetLife/Harris Oakmark International Value Fund
- MetLife/Harris Oakmark Large Cap Value Fund
- Schwab International MarketMasters Fund
- Strategic Partners MidCap Value Fund
- SunAmerica Style Focused International Fund
- SunAmerica Style Focused Large Cap Fund
- SunAmerica Style Select Focused Growth & Income Fund

*Large Cap Global strategy not included in strategy for information. Large Cap Global fee schedule is .75% on the first $100M, .65% over, with a $100M minimum.

HA 0000445
CONFIDENTIAL

AVAILABLE PRODUCT OFFERINGS
SERVICES PROVIDED BY HARRIS ASSOCIATES L.P.

Product	Services Provided by HALP[1]
Oakmark Funds	Investment advisory services
	Trading
	Administrative services
	• Post effective amendment
	• Shareholder communications
	Service provider oversight
	• Transfer agent operations
	• Custodian operations
	• Printing operations
	• Intermediaries
	Trustee support
	• Board and committee meetings
	• Trustee compensation
	• Trustee information and education
	Risk management
	• Disaster recovery plan
	• Audits
	• Insurance
	• State filings
	• Codes of ethics and compliance
	Marketing

[1] Reference is made to Item C.1 of the Management Contracts Committee Responses to Information Request. All of the services described in C.1 are provided to the Oakmark Funds. More limited services are provided for other products as noted.

Sub-Advised Funds	Investment advisory services Trading Shareholder communications • Manager commentary • Sarbanes-Oxley certification (portfolio holdings) Risk management • Disaster recovery plan • Code of ethics and compliance (limited) Marketing
Separate Accounts	Investment advisory services Trading Client reporting (transactions/ performance) Client account services (disbursements, tax reporting, client inquiries, etc.) Risk management • Disaster recovery plan • Audits • Code of ethics and compliance Marketing
Limited Partnerships	Investment advisory services Trading Investor communications (quarterly reports) Quarterly reports to investors Annual prospectus update Processing subscriptions/redemptions

Risk management

- Disaster recovery plan
- Audits
- State filings
- Compliance (limited)

Marketing

FORM ADV OMB: 3235-0049

UNIFORM APPLICATION FOR INVESTMENT ADVISER REGISTRATION

Primary Business Name: HARRIS ASSOCIATES LP	IARD/CRD Number: 106960
	Rev. 05/2003

WARNING: Complete this form truthfully. False statements or omissions may result in denial of your application, revocation of your registration, or criminal prosecution. You must keep this form updated by filing periodic amendments. See Form ADV General Instruction 3.

Item 1 Identifying Information

Responses to this Item tell us who you are, where you are doing business, and how we can contact you.

A. Your full legal name (if you are a sole proprietor, your last, first, and middle names):
HARRIS ASSOCIATES LP

B. Name under which you primarily conduct your advisory business, if different from Item 1.A.
HARRIS ASSOCIATES LP
List on Section 1.B. of Schedule D any additional names under which you conduct your advisory business.

C. If this filing is reporting a change in your legal name (Item 1.A.) or primary business name (Item 1.B.), enter the new name and specify whether the name change is of
☐ your legal name or ☐ your primary business name:

D. If you are registered with the SEC as an investment adviser, your SEC file number: 801- 50333

E. If you have a number ("CRD Number") assigned by the NASD's CRD system or by the IARD system, your CRD number: 106960
If your firm does not have a CRD number, skip this Item 1.E. Do not provide the CRD number of one of your officers, employees, or affiliates.

F *Principal Office and Place of Business*

(1) Address (do not use a P.O. Box):

Number and Street 1:		Number and Street 2:	
TWO NORTH LASALLE STREET, STE 500			
City:	State:	Country:	ZIP+4/Postal Code:
CHICAGO	IL	USA	60602-3790

If this address is a private residence, check this box: ☐
List on Section 1.F. of Schedule D any office, other than your principal office and place of business, at which you conduct investment advisory business. If you are applying for registration, or are registered, with one or more state securities authorities, you must list all of your offices in the state or states to which you are applying for registration or with whom you are registered. If you are applying for registration, or are registered only, with the SEC, list the largest five offices in terms of numbers of employees.

(2) Days of week that you normally conduct business at your *principal office and place of business*:
☒ Monday-Friday ☐ Other:
Normal business hours at this location:
8:30 A.M. - 5:00 P.M.

(3) Telephone number at this location:
312-621-0600

(4) Facsimile number at this location:
312-621-0636

G. Mailing address, if different from your *principal office and place of business* address:

Number and Street 1:		Number and Street 2:		
City:	State:	Country:	ZIP+4/Postal Code:	HA 0000238

BEST AVAILABLE COPY

EXHIBIT 2

STATEMENT OF ADDITIONAL INFORMATION

January 31, 2004

THE OAKMARK FAMILY OF FUNDS

No-Load Funds

Two North LaSalle Street
Chicago, Illinois 60602-3790
Telephone 1-800-OAKMARK
(1-800-625-6275)
www.oakmark.com

This Statement of Additional Information relates to The Oakmark Fund ("Oakmark Fund"), The Oakmark Select Fund ("Select Fund"), The Oakmark Small Cap Fund ("Small Cap Fund"), The Oakmark Equity and Income Fund ("Equity and Income Fund"), The Oakmark Global Fund ("Global Fund"), The Oakmark International Fund ("International Fund") and The Oakmark International Small Cap Fund ("International Small Cap Fund"), each a series of Harris Associates Investment Trust (the "Trust"). This Statement of Additional Information is not a prospectus but provides information that should be read in conjunction with the Funds' prospectus dated the same date as this Statement of Additional Information and any supplement thereto. You may obtain a prospectus or semi-annual or annual report from the Funds at no charge by writing, telephoning or accessing the Funds at their address, telephone number or website shown above.

[Table of Contents Omitted]

THE FUNDS

Oakmark Fund, Select Fund, Small Cap Fund, Global Fund, International Fund and International Small Cap Fund seek long-term capital appreciation.

Equity and Income Fund seeks high current income and preservation and growth of capital.

The Funds are series of the Trust, an open-end management investment company, and each Fund other than Select Fund is diversified. The Trust is a Massachusetts business trust organized under an Agreement and Declaration of Trust dated February 1, 1991 (the "Declaration of Trust").

All shares issued will be fully paid and non-assessable and will have no preemptive or conversion rights.

Each Fund's shares are divided into two share classes: Class I Shares and Class II Shares. Class I Shares of each Fund are offered to members of the general public. As described more fully in the prospectus, Class II Shares of each Fund are offered to certain retirement and profit sharing plans. Class II Shares of a Fund pay a service fee at the annual rate of .25% of the average net assets of Class II Shares of the Fund. This service fee is paid to an administrator for performing the services associated with the administration of such retirement plans. The shares of each class of a Fund represent an interest in the same portfolio of investments of the Fund. All shares of a Fund have equal voting rights (except as to matters affecting the interests of only one class) and the shares of each class are entitled to participate pro rata in any dividends and other distributions declared by the Trust's board of trustees. All shares of a Fund of a given class have equal rights in the event of liquidation of that class.

* * * * *

INVESTMENT ADVISER

The Adviser furnishes continuing investment supervision to the Funds and is responsible for overall management of the Funds' business affairs pursuant to investment advisory agreements relating to the respective Funds (the "Agreements"). The Adviser furnishes office space, equipment and personnel to the Funds, and assumes the expenses of printing and distributing the Funds' prospectus, profiles and reports to prospective investors.

Each Fund pays the cost of its custodial, stock transfer, dividend disbursing, bookkeeping, audit and legal services. Each Fund also pays other expenses such as the cost of proxy solicitations, printing and distributing notices and copies of the prospectus and shareholder reports furnished to existing shareholders, taxes, insurance premiums, the expenses of maintaining the registration of that Fund's shares under federal and state securities laws and the fees of trustees not affiliated with the Adviser.

For its services as investment adviser, the Adviser receives from each Fund a monthly fee based on that Fund's net assets at the end of the preceding month. Basing the fee on net assets at the end of the preceding month has the effect of (i) delaying the impact of changes in assets on the amount of the fee and (ii) in the first year of a fund's operation, reducing the amount of the aggregate fee by providing for no fee in the first month of operation. The annual rates of fees as a percentage of each Fund's net assets are as follows:

Fund	Fee
Oakmark	1.00% up to $2.0 billion; .90% on the next $1.0 billion; .80% on the next $2.0 billion; and .75% on net assets in excess of $5.0 billion
Select	1.00% up to $1.0 billion; .95% on the next $500 million; .90% on the next $500 million; .85% on the next $500 million; .80% on the next $2.5 billion; and .75% on net assets in excess of $5.0 billion
Small Cap	1.00%
Equity and Income	0.75% up to $5 billion; 0.70% on the next $2.5 billion; 0.675% on the next $2.5 billion; and 0.65% on net assets in excess of $10 billion
Global	1.00% up to $2 billion; 0.95% on the next $2 billion; and 0.90% on net assets in excess of $4 billion
International	1.00% up to $2.0 billion; .95% on the next $1.0 billion; and .85% on net assets in excess of $3 billion
International Small Cap	1.25% up to $500 million; and 1.10% on net assets in excess of $500 million

The table below shows gross advisory fees paid by the Funds and any expense reimbursements by the Adviser to them, which are described in the prospectus.

Fund	Type of Payment	Year Ended September 30, 2003	Year Ended September 30, 2002	Year Ended September 30, 2001
Oakmark	Advisory fee	$37,074,474	$34,848,853	$25,662,135
Select	Advisory fee	38,938,068	40,838,462	27,774,016
Small Cap	Advisory fee Reimbursement	3,492,495 654	4,121,533 –	2,490,470 –
Equity and Income	Advisory fee	23,468,519	12,099,581	1,591,905
Global	Advisory fee Reimbursement	2,982,092 –	1,333,497 –	387,377 20,815
International	Advisory fee	19,015,386	12,048,977	8,269,717
International Small Cap	Advisory fee	4,626,713	3,860,436	1,238,024

The Agreement for each Fund was for an initial term that expired on October 31, 2001. Each Agreement continues from year to year thereafter so long as such continuation is approved at least annually by (1) the board of trustees or the vote of a majority of the outstanding voting securities of the Fund, and (2) a majority of the trustees who are not interested persons of any party to the Agreement, cast in person at a meeting called for the purpose of voting on such approval. Each Agreement may be terminated at any time, without penalty, by either the Trust or the Adviser upon 60 days' written notice, and automatically terminates in the event of its assignment as defined in the 1940 Act.

* * * * *

TRUSTEES AND OFFICERS

The board of trustees has overall responsibility for the Funds' operations. Each of the trustees and officers serves until the election and qualification of his or her successor, or until he or she sooner dies, resigns, or is removed or disqualified. The retirement age for trustees is 72. Information regarding the trustees and officers of the Trust including their principal business activities during the past five years is set forth below:

Trustees Who Are Not Interested Persons of the Trust

Name, Address[1] and Age at December 31, 2003	Position(s) with Trust	Date First Elected or Appointed to Current Office	Principal Occupation(s) Held During Past Five Years[2]	Number of Portfolios in Fund Overseen by Trustee	Other Directorships Held by Trustee
Victor A. Morgenstern, 61	Trustee and Chairman of the Board of Trustees	1991	President, Resolute Advisors, Inc. (private investment management firm) since 2002; Chairman, Value Equity Partners, LLC (private equity fund) since 2002; Managing Partner, Dell Hall Partners LLC; Chairman of the Board, HAI, 1996 – 2000; President and Chief Executive Officer prior thereto; Chairman, Hams Partners, L.L.C., 1995 – 2000.	7	Trustee, Illinois Institute of Technology (educational institution); Director, Bio-Sonic Pharmaceuticals Inc. (developer of hormone therapy products)
Michael J. Fridbus, 61	Trustee	1995	Principal, MJ Fridbus & Associates, Inc. (telecommunications consultants)	7	None
Thomas H. Hayden, 52	Trustee	1998	President, Greenhouse Communications (advertising agency) since 2004; Executive Vice President, Campbell Mithun (prior thereto) (advertising and marketing communication agency)	7	None
Christine M. Maki, 43	Trustee	1996	Vice President—Tax, Hyatt Corporation (hotel management)	7	Director, Illinois CPA Society
Allan J. Reich, 55	Trustee	1993	Partner, Seyfarth Shaw LLP (law firm) since 2003; Vice Chairman of the law firm D'Ancona & Pflaum LLC prior thereto	7	None
Mary R. Rotter, 57	Trustee	1995	Senior Advisor to Chief Executive Officer, AXA Advisors, LLC (formerly named Rotter & Associates)	7	None
Burton W. Ryder, 60	Trustee	1995	President, The Academy Financial Group (venture capital investment and transaction financing firm); Manager, Cedar Glenn Associates (real estate management firm)	7	None
Gary R. Wilmer, M.D., 63	Trustee	1993	Senior Attending Physician, Evanston Hospital; Medical Director – Cardio-Pulmonary Wellness Program, Evanston Hospital Corporation	7	Director, North American Scientific, Inc. (developer of radiotherapeutic products for the treatment and diagnosis of disease)

Trustees Who are Interested Persons of the Trust

Name, Address* and Age at December 31, 2003	Position(s) with Trust	Date First Elected or Appointed to Current Office	Principal Occupation(s) Held During Past Five Years*	Number of Portfolios in Fund Overseen by Trustee	Other Directorships Held by Trustee
Peter S. Voss*, 57	Trustee	1995	President and Chief Executive Officer, CDC IXIS Asset Management North America, L.P., formerly known as IXIS Companies L.P. and its predecessor firms (investment management); Director, HAI	7	Chairman, AEW Real Estate Income Fund (closed-end investment company); Chairman and Chief Executive Officer, CDC Nvest Funds (open-end investment company – 14 portfolios)
John H. Ralf*, 49	Trustee and President	2003++	President and Chief Executive Officer, HAI, HASLP and HALP, since 2003; Chief Operating Officer, HALP 2001- 2002; Director of Research, HALP 1998 – 2002; and Associate Director of Research, HALP, prior thereto	7	

Other Officers of the Trust

Name, Address* and Age at December 31, 2003	Position(s) with Trust	Date First Elected or Appointed to Current Office	Principal Occupation(s) Held During Past Five Years*
Robert M. Levy, 53	President	2001	Chairman, HAI, Chief Investment Officer, HALP, since 2001; President and Chief Executive Officer, HAI, HALP and HASLP, 1997 – 2002; Portfolio Manager, HALP
James P. Benson, 46	Vice President and Portfolio Manager (The Oakmark Small Cap Fund)	2000	Portfolio Manager and Analyst, HALP
Henry R. Berghoef, 54	Vice President and Portfolio Manager (The Oakmark Select Fund),	2000	Director of Domestic Research, HALP, since 2003; Associate Director of Research, 2001 – 2002; Portfolio Manager and Analyst, HALP
Kevin G. Grant, 39	Vice President and Portfolio Manager (The Oakmark Fund)	2000	Portfolio Manager and Analyst, HALP

Name, Address[1] and Age at December 31, 2003	*Position(s) with Trust*	*Date First Elected or Appointed to Current Office*	*Principal Occupation(s) Held During Past Five Years[2]*
David G. Herro, 43	Vice President and Portfolio Manager (The Oakmark International Fund and The Oakmark International Small Cap Fund)	1992	Director of International Equities; Portfolio Manager and Analyst, HALP
John J. Kane, 32	Assistant Treasurer	1999	Manager - Fund Accounting, HALP
Clyde S. McGregor, 51	Vice President and Portfolio Manager (The Oakmark Equity and Income Fund and The Oakmark Global Fund)	1995	Portfolio Manager, HALP
William C. Nygren, 45	Vice President and Portfolio Manager (The Oakmark Fund and The Oakmark Select Fund)	1996	Portfolio Manager and Analyst, HALP, former Director of Research, HALP
Vineeta D. Rakelich, 32	Vice President	2003	Manager, International Operations and Client Relations, HALP; Supervisor, Mutual Fund and Institutional Services, HALP, prior thereto
Janet L. Reali, 52	Vice President and Secretary	2001	Vice President, General Counsel and Secretary, HAI, HALP and HASLP since 2001; Senior Executive Vice President, General Counsel and Secretary, Everen Capital Corp. and Everen Securities, Inc. 1995-1999 (broker/dealer)
Ann W. Regan, 55	Vice President–Shareholder Operations and Assistant Secretary	1996	Director of Mutual Fund Operations, HALP
Kristi L. Rowsell, 37	Treasurer	1997	Director, Chief Financial Officer and Treasurer, HAI; Chief Financial Officer, HALP and HASLP since 1999
Edward A. Studzinski, 54	Vice President and Portfolio Manager (The Oakmark Equity and Income Fund and The Oakmark Small Cap Fund)	2000	Portfolio Manager and Analyst, HALP

Name, Address[†] and Age at December 31, 2003	*Position(s) with Trust*	*Date First Elected or Appointed to Current Office*	*Principal Occupation(s) Held During Past Five Years[#]*
Michael J. Welsh, 40	Vice President and Portfolio Manager (The Oakmark Global Fund, The Oakmark International Fund and The Oakmark International Small Cap Fund)	1997	Director of International Equities; Portfolio Manager and Analyst, HALP

[†] Unless otherwise noted, the business address of each officer and trustee listed in the table is Two North LaSalle Street, Suite 500, Chicago, Illinois 60602-3790.

[#] As used in this table, "HALP," "HAI" and "HASLP" refer to the Adviser, the general partner of the Adviser, and the Fund's distributor, respectively.

[++] Mr. Raitt succeeded Mr. Levy as President of the Trust on January 1, 2004.

[*] Mr. Voss and Mr. Raitt are trustees who are "interested persons" of the Trust as defined in the 1940 Act because Mr. Voss is an officer of the Adviser's parent company, and Mr. Raitt is an officer of the Adviser.

The committees of the board of trustees including an executive committee, audit committee, governance committee and management contracts committee. The following table identifies the members of those committees, the function of each committee, and the number of meetings of each committee held during the fiscal year ended September 30, 2003.

Committee	Members of Committee	Number of meetings during fiscal year ended September 30, 2003	Principal Functions of Committee
Executive Committee	Victor A. Morgenstern* Peter S. Voss Christine M. Maki	10**	The executive committee generally has the authority to exercise the powers of the board during intervals between meetings.
Audit Committee	Thomas H. Hayden Christine M. Maki Allan J. Reich* Gary N. Wilner, M.D. Marvin R. Rotter	6	The principal responsibilities of the audit committee include the following: • to oversee the accounting and financial reporting policies and practices of the Trust, its internal controls and, as appropriate, the internal controls of certain service providers; • to oversee the quality and objectivity of the financial statements of the Funds and the independent audits thereof; • to approve the selection of the Independent Auditors of the Funds; • to act as liaison between the independent auditors of the Funds and the full board of trustees; and • to oversee the portfolio transaction policies and practices of the Funds.
Governance Committee	Michael J. Friduss Christine M. Maki Victor A. Morgenstern Allan J. Reich Burton W. Rubin Gary N. Wilner, M.D.*	4	The governance committee makes recommendations to the board regarding board committees and committee assignments, the composition of the board, candidates for election as non-interested trustees and compensation of non-interested trustees, and oversees the process for evaluating the functioning of the board.
Management Contracts Committee	Michael J. Friduss Thomas H. Hayden* Victor A. Morgenstern Mary R. Rotter Burton W. Rubin	4	The committee on management contracts is responsible for reviewing in the first instance, and making recommendations to the board regarding, investment advisory agreements and any other agreements relating to the management or administration of any Fund.

* Chairperson of the committee.

** The executive committee held four meetings and took action by unanimous written consent of the committee members six times.

The following table shows the compensation paid by the Trust* for the fiscal year ended September 30, 2003 to each trustee who was not an "interested person" of the Trust:

Name of Trustee	Aggregate Compensation from the Trust**	Average Compensation per Fund
Victor A. Morgenstern	$137,600	$19,657
Michael J. Friduss	87,800	12,543
Thomas H. Hayden	88,300	12,614
Christine M. Maki	88,800	12,686
Allan J. Reich	88,300	12,614
Mary R. Rotter	78,000	11,143
Burton W. Ruder	85,600	12,229
Gary N. Wilner, M.D.	82,700	11,814

* The Trust is not part of a fund complex.

** Includes compensation that was deferred pursuant to a deferred compensation plan. As of September 30, 2003, the total amounts accrued under the plan were $395,655 for Mr. Friduss, $320,098 for Mr. Hayden, $327,974 for Ms. Maki, $337,082 for Mr. Rotter, $323,115 for Mr. Ruder and $398,183 for Dr. Wilner.

Trustees who are "interested persons" of the Trust, as well as the officers of the Trust, are compensated by the Adviser and not by the Trust. The Trust does not provide any pension or retirement benefits to its trustees.

The Trust has a deferred compensation plan (the "Plan") that permits any trustee who is not an "interested person" of the Trust to elect to defer receipt of all or a portion of his or her compensation as a trustee for two or more years. The deferred compensation of a participating trustee is credited to a book reserve account of the Trust when the compensation would otherwise have been paid to the trustee. The

value of the trustee's deferral account at any time is equal to the value that the account would have had if contributions to the account had been invested and reinvested in shares of one or more of the Oakmark Funds or the Goldman Sachs Institutional Liquid Assets Government Portfolio as designated by the trustee. At the time for commencing distributions from a trustee's deferral account, which is no later than when the trustee ceases to be a member of the board of trustees, the trustee may elect to receive distributions in a lump sum or over a period of five years. Each Fund's obligation to make distributions under the Plan is a general obligation of that Fund. No Fund will be liable for any other Fund's obligations to make distributions under the Plan.

The following table illustrates the value of each Fund "beneficially" owned (within the meaning of that term as defined in rule 16a-1(a)(2) under the Securities Exchange Act of 1934) by each trustee (within dollar ranges) as of December 31, 2003.

Trustee	Oakmark Fund	Select Fund	Small Cap Fund	Equity and Income Fund	Global Fund	International Fund	International Small Cap Fund
Victor A. Morgenstern	over $100,000	over $100,000	over $100,000	$10,001 - 50,000	over $100,000	over $100,000	over $100,000
Michael J. Friduss	over $100,000	over $100,000	$50,001 - 100,000	over $100,000	over $100,000	$50,001 - 100,000	Over $100,000
Thomas H. Hayden	$10,001 - 50,000	over $100,000	None	$10,001 - 50,000	$10,001 - 50,000	None	None
Christine M. Maki	$10,001 - 50,000	$50,001 - 100,000	$10,001 - 50,000	$10,001 - 50,000	$1 - 10,000	$10,001 - 50,000	$10,001 50,000
Allan J. Reich	over $100,000	over $100,000	$1 - 10,000	$50,001 - 100,000	$10,001 - 50,000	$10,001 - 50,000	$1 - 10,000
Marvin R. Rotter	None	None	None	None	None	None	None
Burton W. Ruder	None	$10,001 - 50,000	$10,001 - 50,000	$1 - 10,000	over $100,000	over $100,000	over $100,000
Peter S. Voss	over $100,000	over $100,000	None	None	None	over $100,000	over $100,000
Gary N. Wilner, M.D.	$50,001 - 100,000	$50,001 - 100,000	$50,001 - 100,000	$1 - 10,000	$10,001 - 50,000	$50,001 - 100,000	$10,001 - 50,000

At December 31, 2003 the trustees and officers as a group owned beneficially less than 1% of the outstanding Class II shares of each Fund and Class I shares of Oakmark Fund, Equity and Income Fund, and International Fund and the following percentages of the outstanding shares of each of the other Funds: Select, 1.13%; Small Cap, 1.54%, Global, 1.55% and International Small Cap, 2.02%.

* * * * *

PURCHASING AND REDEEMING SHARES

Purchases and redemptions are discussed in the Funds' prospectus under the headings "Investing with The Oakmark Family of Funds," "How to Buy Class I Shares," "How to Sell Class I Shares" and "Shareholder Services."

Net Asset Value

The net asset value per Class I Share or per Class II Share of each Fund is determined by the Trust's custodian. The net asset value of Class I Shares of a Fund is determined by dividing the value of the assets attributable to Class I Shares of the Fund, less liabilities attributable to that class, by the number of Class I Shares outstanding. Similarly, the net asset value of Class II Shares of a Fund is determined by dividing the value of the assets attributable to Class II Shares of the Fund, less liabilities attributable to that class, by the number of Class II Shares outstanding. Domestic securities traded on securities exchanges are generally valued at the last sale price on the exchange where the security is principally traded, or lacking a reported sale at the time of valuation, at the most recent bid quotation. Each over-the-counter security traded on the NASDAQ National Market System shall be valued at the

NASDAQ Official Closing Price ("NOCP"), or lacking a NOCP at the time of valuation, at the most recent bid quotation. Other over-the-counter securities are valued at the last sales prices at the time of valuation or, lacking any reported sales on that day, at the most recent bid quotations. The values of securities of non-U.S. issuers that are traded on an exchange are generally based upon market quotations which, depending upon local convention or regulation, may be last sale price, last bid or asked price, the mean between last bid and asked prices, an official closing price, or may be valued based on a pricing composite. The market value of exchange-traded securities is determined by using prices provided by one or more professional pricing services, or, as needed, by obtaining market quotations from independent broker-dealers. Debt obligations and money market instruments maturing in more than 60 days from the date of purchase are valued at the latest bid quotation. Debt obligations and money market instruments with a maturity of 60 days or less from the date of purchase are valued on an amortized cost basis. Securities for which quotations are not available and any other assets are valued at a fair value as determined in good faith by or under the direction of the board of trustees. All assets and liabilities initially expressed in foreign currencies are converted into U.S. dollars at the mean of the bid and offer prices of such currencies against U.S. dollars quoted by any major bank or dealer. If such quotations are not available, the rate of exchange will be determined in accordance with policies established in good faith by or under the direction of the board of trustees.

The Funds' net asset values are determined only on days on which the New York Stock Exchange (the "NYSE") is open for trading. The NYSE is regularly closed on Saturdays and Sundays and on New Year's Day, the third Monday in January and February, Good Friday, the last Monday in May, Independence Day, Labor Day, Thanksgiving and Christmas. If one of these holidays falls on a Saturday or Sunday, the NYSE will be closed on the preceding Friday or the following Monday, respectively.

Trading in the portfolio securities of International Fund, International Small Cap Fund or Global Fund (and of any other Fund, to the extent it invests in securities of non-U.S. issuers) takes place in various foreign markets on certain days (such as Saturday) when the Fund is not open for business and does not calculate its net asset value. In addition, trading in the Fund's portfolio securities may not occur on days when the Fund is open. Therefore, the calculation of net asset value does not take place contemporaneously with the determinations of the prices of many of the Fund's portfolio securities and the value of the Fund's portfolio may be significantly affected on days when shares of the Fund may not be purchased or redeemed. Even on days on which both the foreign markets and the NYSE are open, several hours may have passed between the time when trading in a foreign market closes and the NYSE closes and the Funds calculate their net asset values. The Funds monitor for significant events in foreign markets. A Fund may price a security of a non-U.S. issuer at a fair value determined according to procedures adopted by the board of trustees if it appears that the value of the security has been materially affected by events occurring between the close of the primary

market or exchange on which the security is traded and the time for computing net asset value.

Computation of net asset value (and the sale and redemption of a Fund's shares) may be suspended or postponed during any period when (a) trading on the NYSE is restricted, as determined by the SEC, or that exchange is closed for other than customary weekend and holiday closings, (b) the SEC has by order permitted such suspension, or (c) an emergency, as determined by the SEC, exists making disposal of portfolio securities or valuation of the net assets of a Fund not reasonably practicable.

Shares Purchased through Intermediaries

Class I Shares of any of the Funds may be purchased through certain financial service companies, such as broker-dealers, banks, retirement plan service providers and retirement plan sponsors, who are agents of the Funds for the limited purpose of receiving and transmitting instructions for the purchase or sale of fund shares ("Intermediaries"). Class II Shares of each Fund are offered only for purchase through certain retirement plans, such as 401(k), and profit sharing plans. To purchase Class II Shares, you must do so through an Intermediary.

An Intermediary accepts purchase and sale orders as an authorized agent of the Funds pursuant to a written agreement. Any purchase or sale is made at the net asset value next determined after receipt and acceptance of the order by the Intermediary. Federal securities laws require Intermediaries to segregate any orders received on a business day after the close of regular session trading on the NYSE and transmit those orders separately for execution at the net asset value next determined after that business day. The

Funds have no ability to verify compliance by the Intermediaries with that requirement.

For services provided by an Intermediary with respect to Fund shares held through that Intermediary for its customers, the Intermediary may charge the Fund and the Adviser a fee of up to 0.40% of the average annual value of such shares. Each Fund may pay a portion of those fees, not to exceed the estimated fees that the Fund would pay to its own transfer agent if those shares were registered directly in the customers' names on the books of the Fund's transfer agent. The balance of those fees are paid by the Adviser. Class II Shares of a Fund pay to Intermediaries an additional service fee of .25% of the average annual value of Class II Shares of the Fund purchased or held through the Intermediaries for services associated with the administration of retirement plans.

The Trust reserves the right to waive minimum investment requirements for purchases made through Intermediaries.

Redemption in Kind

Each Fund elected to be governed by Rule 18f-1 under the 1940 Act pursuant to which it is obligated to redeem shares solely in cash up to the lesser of $250,000 or 1% of the net asset value of a Fund during any 90-day period for any one shareholder. Redemptions in excess of those amounts will normally be paid in cash, but may be paid wholly or partly by a distribution in kind of marketable securities. Brokerage costs may be incurred by a shareholder who receives securities and desires to convert them to cash.

Redemption of Small Accounts

Due to the relatively high cost of maintaining small accounts, each Fund reserves the right to redeem shares in any account, including any account held in the name of an Intermediary, and send the proceeds to the registered owner of the account if the account value has been reduced below $1,000 as a result of redemptions. A Fund or its agent will make a reasonable effort to notify the registered owner if the account falls below the minimum in order to give the owner 30 days to increase the account value to $1,000 or more. The agreement and declaration of trust also authorizes the Trust to redeem shares under certain other circumstances as may be specified by the board of trustees.

90-Day Redemption Fee – Class I Shares

Each Fund imposes a short-term trading fee on redemptions of Class I Shares held for 90 days or less to offset two types of costs to the Fund caused by short-term trading: portfolio transaction and market impact costs associated with erratic redemption activity and administrative costs associated with processing redemptions. The fee is 2% of the redemption value and is deducted from the redemption proceeds. The "first-in, first-out" (FIFO) method is used to determine the holding period, which means that if you bought shares on different days, the shares purchased first will be redeemed first for purposes of determining whether the short-term trading fee applies.

No Fund imposes a redemption fee on a redemption of:

- shares acquired by reinvestment of dividends or distributions of a Fund; or

- shares held in an account of certain retirement plans or profit sharing plans or purchased through certain Intermediaries.

Money Market Exchange Fund

The Adviser acts as a Service Organization for the Institutional Liquid Assets Service Units ("Oakmark Units") of the Government Portfolio of Goldman Sachs Trust, which Oakmark Units may be purchased directly or by exchanging shares of a Fund. For its services, the Adviser receives fees at a rate of .50% of the average annual net assets of the portfolio, pursuant to a 12b-1 plan adopted by the Goldman Sachs Trust.

Mutual Fund Anti-money Laundering Disclosure

The Funds are required to comply with various anti-money laundering laws and regulations. Consequently, a Fund may be required to "freeze" the account of a shareholder if the shareholder appears to be involved in suspicious activity or if certain account information matches information on government lists of known terrorists or other suspicious persons, or the Fund may be required to transfer the account or proceeds of the account to a government agency.

* * * * *

EXHIBIT 3

STATEMENT OF ADDITIONAL INFORMATION

January 28, 2005

THE OAKMARK FUNDS

No-Load Funds

Two North LaSalle Street
Chicago, Illinois 60602-3790
Telephone 1-800-OAKMARK
(1-800-625-6275)
www.oakmark.com

This Statement of Additional Information relates to The Oakmark Fund ("Oakmark Fund"), The Oakmark Select Fund ("Select Fund"), The Oakmark Equity and Income Fund ("Equity and Income Fund"), The Oakmark Global Fund ("Global Fund"), The Oakmark International Fund ("International Fund") and The Oakmark International Small Cap Fund ("International Small Cap Fund"), each a series of Harris Associates Investment Trust (the "Trust"). This Statement of Additional Information is not a prospectus but provides information that should be read in conjunction with the Funds' prospectus dated the same date as this Statement of Additional Information and any supplement thereto. You may obtain a prospectus or semi-annual or annual report from the Funds at no charge by writing, telephoning or accessing the Funds at their address, telephone number or website shown above.

[Table of Contents Omitted]

* * * * *

INVESTMENT ADVISER

The Adviser furnishes continuing investment supervision to the Funds and is responsible for overall management of the Funds' business affairs pursuant to investment advisory agreements relating to the respective Funds (the "Agreements"). The Adviser furnishes office space, equipment and personnel to the Funds, and assumes the expenses of printing and distributing the Funds' prospectus, profiles and reports to prospective investors.

Each Fund pays the cost of its custodial, stock transfer, dividend disbursing, bookkeeping, audit and legal services. Each Fund also pays other expenses such as the cost of proxy solicitations, printing and distributing notices and copies of the prospectus and shareholder reports furnished to existing shareholders, taxes, insurance premiums, the expenses of maintaining the registration of that Fund's shares under federal and state securities laws and the fees of trustees not affiliated with the Adviser.

For its services as investment adviser, the Adviser receives from each Fund a monthly fee based on that Fund's net assets at the end of the preceding month. Basing the fee on net assets at the end of the preceding month has the effect of (i) delaying the impact of changes in assets on the amount of the fee and (ii) in the first year of a fund's operation, reducing the amount of the aggregate fee by providing for no fee in the first month of operation. The annual rates of fees as a percentage of each Fund's net assets are as follows:

Fund	Fee
Oakmark	1.00% up to $2.0 billion; 0.90% from $2-3 billion; 0.80% from $3-5 billion; 0.75% from $5-7.5 billion; 0.70% from $7.5-10 billion; and 0.65% over $10 billion
Select	1.00% up to $1.0 billion; 0.95% from $1-1.5 billion; 0.90% from $1.5-2 billion; 0.85% from $2-2.5 billion; 0.80% from $2.5-5 billion; 0.75% from $5-10 billion; and 0.725% over $10 billion
Equity and Income	0.75% up to $5 billion; 0.70% from $5-7.5 billion; 0.675% from $7.5-10 billion; 0.65% from $10-12.5 billion; and 0.60% over $12.5 billion
Global	1.00% up to $2 billion; 0.95% from $2-4 billion; and 0.90% over $4 billion
International	1.00% up to $2.0 billion; 0.95% from $2-3 billion; 0.85% from $3-5 billion; 0.825% from $5-7.5 billion; 0.815% over $7.5 billion
International Small Cap	1.25% up to $500 million; 1.10% from $500 million to $1.5 billion; and 1.05% over $1.5 billion

The table below shows gross advisory fees paid by the Funds and any expense reimbursements by the Adviser to them, which are described in the prospectus.

Fund	Type of Payment	Year Ended September 30, 2004	Year Ended September 30, 2003	Year Ended September 30, 2002
Oakmark	Advisory fee	$50,652,178	$37,074,474	$34,848,853
Select	Advisory fee	48,070,958	38,938,068	40,838,462
Equity and Income	Advisory fee	46,997,810	23,468,519	12,099,581
Global	Advisory fee	12,245,761	2,982,092	1,333,497
International	Advisory fee	36,337,644	19,015,386	12,048,977
International Small Cap	Advisory fee	7,616,526	4,626,713	3,860,436

The Agreement for each Fund was for an initial term that expired on October 31, 2001. Each Agreement continues from year to year thereafter so long as such continuation is approved at least annually by (1) the board of trustees or the vote of a majority of the outstanding voting securities of the Fund, and (2) a majority of the trustees who are not interested persons of any party to the Agreement, cast in person at a meeting called for the purpose of voting on such approval. Each Agreement may be terminated at any time, without penalty, by either the Trust or the Adviser upon 60 days' written notice, and automatically terminates in the event of its assignment as defined in the 1940 Act.

At a meeting of the board of trustees of the Trust held on October 28, 2004, called in part for the purpose of voting on the renewal of the Agreements, the Agreements, with certain restrictions in the schedule

of advisory fee rates, were renewed through October 31, 2005 by the affirmative vote of a majority of the trustees, and a majority of "non-interested" trustees, voting separately. The trustees considered information about, among other things:

- the Adviser and its personnel (including particularly those personnel with responsibilities for providing services to the Funds), resources and investment processes;
- the terms of each Agreement;
- the scope and quality of services that the Adviser has been providing to the Funds;
- the investment performance of each Fund and of comparable funds managed by other advisers over various periods;
- the advisory fee rates payable by each Fund to the Adviser and by comparable funds managed by other advisers, as well as advisory fee rates payable by other types of accounts managed by the Adviser;
- the total expense ratio of each Fund and of comparable funds managed by other advisers;
- the compensation payable by the Funds to affiliates of the Adviser for other services, and the Adviser's contractual undertaking to limit Fund expenses;
- the profitability of the Adviser and its affiliates from their relationships with the Funds, as well as economies of scale and sharing of those economies with the Funds; and
- the Adviser's use of the Funds' portfolio brokerage transactions to obtain research benefiting the Funds or other clients of the Adviser at

a cost that may be in excess of the amount other brokers would charge.

The action of the trustees to renew the Agreements was taken upon recommendation of the committee on management contracts, which had met several times over the preceding five months, and was taken after successive board meetings at which the agreements were discussed.

The Adviser is a limited partnership managed by its general partner, Harris Associates, Inc. ("HAI"), whose directors are David G. Herro, Robert M. Levy, John R. Raitt, Kristi L. Rowsell, G. Neal Ryland and Peter S. Voss. Mr. Raitt is the president and chief executive officer of HAI. HAI is a wholly-owned subsidiary of IXIS Asset Management North America, L.P. ("IXIS AMNA"). IXIS AMNA owns 99.67% of the limited partnership interests in the Adviser and, through its wholly-owned subsidiary, IXIS Asset Management Holdings, LLC ("IXIS Holdings"), all of the outstanding shares of HAI. IXIS AMNA is a limited partnership that owns investment management and distribution and service entities, including IXIS Asset Management Services Company, the Funds' transfer agent.

IXIS ANNA is part of IXIS Asset Management Group, an international asset management group based in Paris, France. IXIS Asset Management Group is ultimately owned principally, directly or indirectly, by three large affiliated French financial services entities: the Caisse des Depots et Consignations ("CDC"), a public sector financial institution created by the French government in 1816; the Caisse Nationale des Caisses d'Epargne ("CNC"), a financial institution owned by CDC and by French regional savings banks known as the Caisses d'Epar-

gne; and CNP Assurances, a large French life insurance company. The registered address of CNC is 5, rue Masseran, 75007 Paris, France. The registered office of CDC is 56, rue de Lille, 75007 Paris, France. The registered address of CNP Assurances is 4, place Raoul Dautry, 75015 Paris, France.

The Adviser has contractually agreed to reimburse Class I Shares of each Fund to the extent that the annual ordinary operating expenses of that class exceed the following percentages of the average net assets of Class I Shares: 1.50% in the case of Oakmark Fund or Select Fund; 1.00% in the case of Equity and Income Fund; 1.75% in the case of Global Fund; and 2.00% in the case of International Fund and International Small Cap Fund. The Adviser has also contractually agreed to reimburse Class II Shares of each Fund to the extent that the annual ordinary operating expenses of that class exceed the following percentages of the average net assets of Class II Shares: Oakmark Fund or Select Fund, 1.75% (1.50% + .25%); Equity and Income Fund, 1.25% (1.00% + .25%); Global Fund, 2.00% (1.75% + .25%); and International Fund and International Small Cap Fund, 2.25% (2.00% + .25%). Each such agreement is effective through January 31, 2006.

For the purpose of determining whether a share class of a Fund is entitled to any reduction in advisory fee or expense reimbursement, the pro rata portion of the Fund's expenses attributable to a share class of that Fund is calculated daily and any reduction in fee or reimbursement is made monthly.

* * * * *

PURCHASING AND REDEEMING SHARES

Purchases and redemptions are discussed in the Funds' prospectus under the headings "Investing with The Oakmark Funds," "How to Buy Class I Shares," "How to Sell Class I Shares" and "Shareholder Services."

NET ASSET VALUE

The Funds' net asset values are determined only on days on which the New York Stock Exchange (the "NYSE") is open for trading. The NYSE is regularly closed on Saturdays and Sundays and on New Year's Day, the third Monday in January and February, Good Friday, the last Monday in May, Independence Day, Labor Day, Thanksgiving and Christmas. If one of these holidays falls on a Saturday or Sunday, the NYSE will be closed on the preceding Friday or the following Monday, respectively.

The net asset value per Class I Share or per Class II Share of each Fund is determined by the Trust's custodian. The net asset value of Class I Shares of a Fund is determined by dividing the value of the assets attributable to Class I Shares of the Fund, less liabilities attributable to that class, by the number of Class I Shares outstanding. Similarly, the net asset value of Class II Shares of a Fund is determined by dividing the value of the assets attributable to Class II Shares of the Fund, less liabilities attributable to that class, by the number of Class II Shares outstanding. Domestic securities traded on securities exchanges are generally valued at the last sale price on the exchange where the security is principally traded, or lacking a reported sale at the time of valuation, at the most recent bid quotation. Each over-the-counter security traded on the NASDAQ National Market System shall be valued at the NASDAQ Official Closing Price ("NOCP"), or lacking

a NOCP at the time of valuation, at the most recent bid quotation. Other over-the-counter securities are valued at the last sales prices at the time of valuation or, lacking any reported sales on that day, at the most recent bid quotations. The values of securities of non-U.S. issuers that are traded on an exchange are generally based upon market quotations which, depending upon local convention or regulation, may be last sale price, last bid or asked price, the mean between last bid and asked prices, an official closing price, or may be valued based on a pricing composite. The market value of exchange-traded securities is determined by using prices provided by one or more professional pricing services, or, as needed, by obtaining market quotations from independent broker-dealers. Debt obligations and money market instruments maturing in more than 60 days from the date of purchase are valued at the latest bid quotation. Debt obligations and money market instruments with a maturity of 60 days or less from the date of purchase are valued on an amortized cost basis. Securities for which quotations are not available and any other assets are valued at a fair value as determined in good faith by or under the direction of the board of trustees. All assets and liabilities initially expressed in foreign currencies are converted into U.S. dollars at the mean of the bid and offer prices of such currencies against U.S. dollars quoted by any major bank or dealer. If such quotations are not available, the rate of exchange will be determined in accordance with policies established in good faith by or under the direction of the board of trustees.

Trading in the portfolio securities of International Fund, International Small Cap Fund or Global Fund (and of any other Fund, to the extent it invests in securities of non-U.S. issuers) takes place in various foreign markets on days (such as Saturday) when the

NYSE is not open and the Funds that may be open do not calculate their net asset value. In addition, trading in the Fund's portfolio securities may not occur on days when the Fund is open. Therefore, the calculation of net asset value does not take place contemporaneously with the determinations of the prices of many of the Fund's portfolio securities and the value of the Fund's portfolio may be significantly affected on days when shares of the Fund may not be purchased or redeemed. Even on days on which both the foreign markets and the NYSE are open, several hours may have passed between the time when trading in a foreign market closes and the NYSE closes and the Funds calculate their net asset values.

Computation of net asset value (and the sale and redemption of a Fund's shares) may be suspended or postponed during any period when (a) trading on the NYSE is restricted, as determined by the SEC, or that exchange is closed for other than customary weekend and holiday closings, (b) the SEC has by order permitted such suspension, or (c) an emergency, as determined by the SEC, exists making disposal of portfolio securities or valuation of the net assets of a Fund not reasonably practicable. A Fund may value a security at a fair value if it appears that the valuation of the security has been materially affected by events occurring after the close of the primary market or exchange on which the security is traded but before the time as of which the net asset value is calculated. The Trust has retained a third party service provider to assist in determining estimates of fair values for foreign securities. That service utilizes statistical data based on historical performance of securities, markets and other data in developing factors used to estimate a fair value. When fair value pricing is employed, the value of a portfolio security used by a Fund to calculate its NAV may

differ from quoted or published prices for the same security. Estimates of fair value utilized by the Funds as described above may differ from the value realized on the sale of those securities and the differences may be material to the net asset value of the applicable Fund.

The Trust has adopted a policy regarding the correction of any error in the computation of NAV in accordance with guidance provided by the SEC. When an error is discovered, the difference between the originally computed (erroneous) NAV and the correct NAV is calculated. If the difference is equal to or less than one cent per share, the error is deemed immaterial and no action is taken. If the difference is greater than one cent per share, the following actions are taken:

Amount of Difference	Action Taken
LESS THAN 1/2 of 1% of the originally computed NAV	The Fund determines whether it has incurred a loss or a benefit. If the Fund has either paid excessive redemption proceeds or received insufficient subscription proceeds ("fund loss"), the party responsible for the error is expected to reimburse the Fund for the amount of the loss. If the Fund has received a benefit from the error, no action is taken.

Amount of Difference	Action Taken
= or GREATER THAN 1/2 of 1% of the originally computed NAV	If any shareholder has sustained a loss exceeding $20, the Fund or the party responsible for the error is expected to pay the shareholder any additional redeemption proceeds owed and either refund excess subscription monies paid or credit the shareholder's account with additional shares as of the date of the error. Either the responsible party or the individual shareholders who experienced a benefit as a result of the error are expected to reimburse the Fund for any fund losses attributable to them.

SHARES PURCHASED THROUGH INTERMEDIARIES

Class I Shares of any of the Funds may be purchased through certain financial service companies, such as broker-dealers, banks, retirement plan service providers and retirement plan sponsors, who are agents of the Funds for the limited purpose of receiving and transmitting instructions for the purchase or sale of fund shares ("Intermediaries"). Class II

Shares of each Fund are offered only for purchase through certain retirement plans, such as 401(k), and profit sharing plans. To purchase Class II Shares, you must do so through an Intermediary.

An Intermediary accepts purchase and sale orders as an authorized agent of the Funds pursuant to a written agreement. Any purchase or sale is made at the net asset value next determined after receipt and acceptance of the order by the Intermediary. Federal securities laws require Intermediaries to segregate any orders received on a business day after the close of regular session trading on the NYSE and transmit those orders separately for execution at the net asset value next determined after that business day. The Funds have no ability to verify compliance by the Intermediaries with that requirement.

For services provided by an Intermediary with respect to Fund shares held through that Intermediary for its customers, the Intermediary may charge a fee of up to 0.40% of the average annual value of such shares. Each Fund may pay a portion of those fees for sub-transfer agency and shareholder servicing services, not to exceed the estimated fees that the Fund would have paid to its own transfer agent if those shares were registered directly in the customers' names on the books of the Fund's transfer agent. The balance of those fees is paid by the Adviser. Intermediaries may be paid from assets attributable to Class II shares of a Fund an additional service fee, at the rate of 0.25% of the average annual value of Class II Shares of the Fund purchased or held through the Intermediaries, for services associated with the administration of retirement plans.

The Trust reserves the right to waive minimum investment requirements for purchases made through Intermediaries.

REDEMPTION IN KIND

Each Fund has elected to be governed by Rule 18f-1 under the 1940 Act pursuant to which it is obligated to redeem shares solely in cash up to the lesser of $250,000 or 1% of the net asset value of a Fund during any 90-day period for any one shareholder. Redemptions in excess of those amounts will normally be paid in cash, but may be paid wholly or partly by a distribution in kind of marketable securities. Brokerage costs may be incurred by a shareholder who receives securities and desires to convert them to cash.

SMALL ACCOUNT FEE AND REDEMPTION POLICY

Due to the relatively high cost of maintaining small accounts, each Fund reserves the right to assess an annual fee of $25 on any account or to redeem all the shares in any account and send the proceeds to the registered owner of the account if the account value has been reduced below $1,000 as a result of redemptions. Prior to redeeming all of the shares in such account, a Fund or its agent will make a reasonable effort to notify the registered owner if the account falls below the minimum in order to give the owner 30 days to increase the account value to $1,000 or more. The agreement and declaration of trust also authorizes the Trust to redeem shares under certain other circumstances as may be specified by the board of trustees.

90-DAY REDEMPTION FEE – CLASS I SHARES

Each Fund imposes a short-term trading fee on redemptions of Class I Shares held for 90 days or less to offset two types of costs to the Fund caused by short-term trading: portfolio transaction and market impact costs associated with erratic redemption activity and administrative costs associated with processing redemptions. The fee is paid to the Fund and is 2% of the redemption value and is deducted from either the redemption proceeds or from the balance of the account. The "first-in, first-out" (FIFO) method is used to determine the holding period, which means that if you bought shares on different days, the shares purchased first will be redeemed first for purposes of determining whether the short-term trading fee applies.

No Fund imposes a redemption fee on a redemption of:

- shares acquired by reinvestment of dividends or distributions of the Fund;
- shares held in an account of certain retirement plans or profit sharing plans or purchased through certain Intermediaries;
- shares redeemed pursuant to a systematic withdrawal plan;
- shares redeemed pursuant to a required minimum distribution;
- shares redeemed from an account that has changed registration; or
- an account that is closed because the Funds cannot verify the owner's identity pursuant to the Funds' customer identification program.

MONEY MARKET EXCHANGE FUND

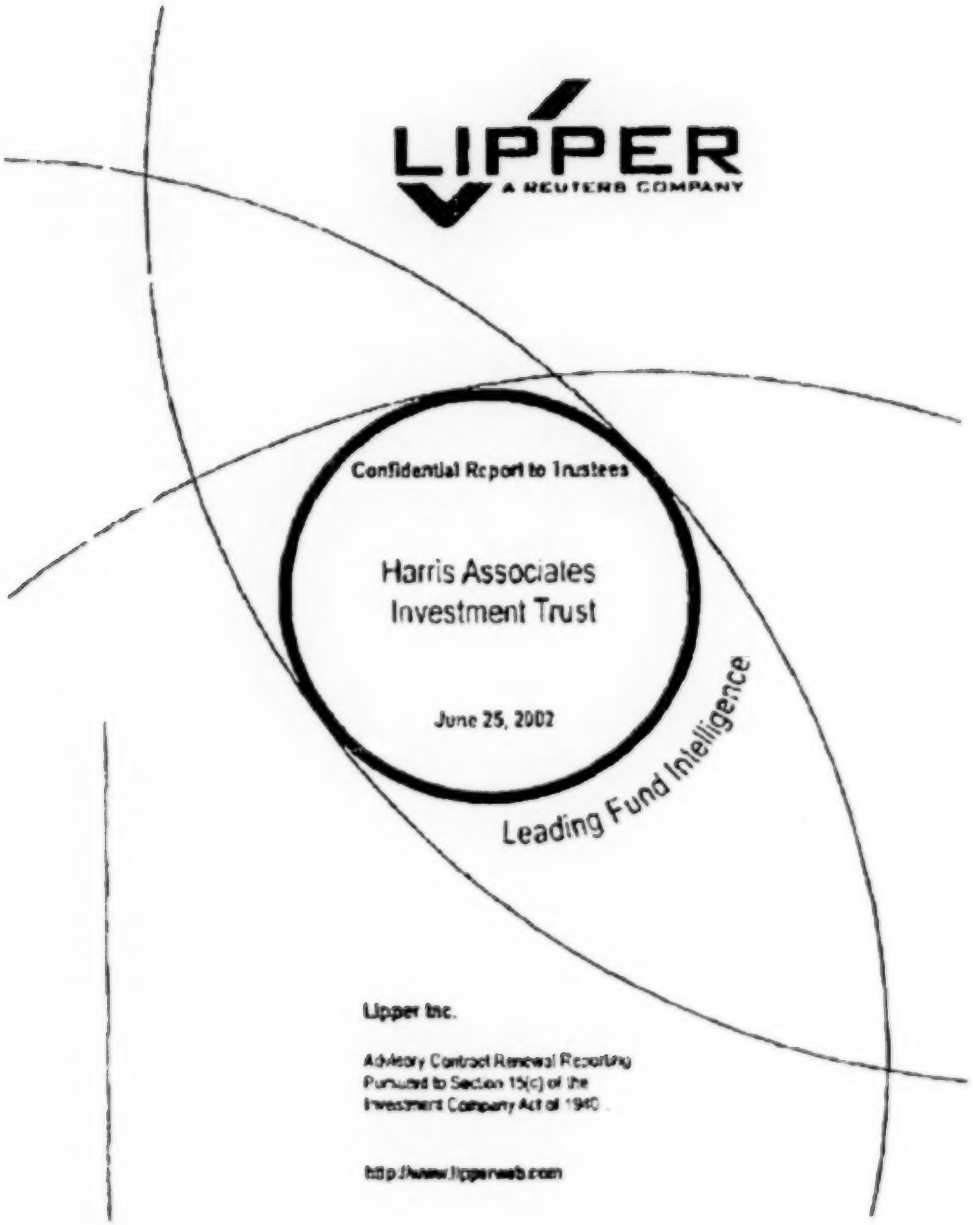
The Adviser acts as a Service Organization for the Institutional Liquid Assets Service Units ("Oakmark Units") of the Government Portfolio of Goldman Sachs Trust, which Oakmark Units may be purchased directly or by exchanging shares of a Fund. For its services, the Adviser receives fees at a rate of 0.50% of the average annual net assets of the portfolio, pursuant to a 12b-1 plan adopted by the Goldman Sachs Trust.

ANTI-MONEY LAUNDERING COMPLIANCE

The Funds are required to comply with various anti-money laundering laws and regulations. Consequently, a Fund may be required to "freeze" the account of a shareholder if the shareholder appears to be involved in suspicious activity or if certain account information matches information on government lists of known terrorists or other suspicious persons, or the Fund may be required to transfer the account or proceeds of the account to a government agency.

* * * * *

EXHIBIT 10


LIPPER
A REUTERS COMPANY
Confidential Report to Trustees
Harris Associates
Investment Trust
June 25, 2002
Leading Fund Intelligence
Lipper Inc.
Advisory Contract Renewal Reporting
Pursuant to Section 15(c) of the
Investment Company Act of 1940
http://www.lipperweb.com

[Copyright Page and Table of Contents Omitted]

Report Background

Lipper and Contract Renewal

Lipper Inc. ("Lipper"), an independent provider of investment company data, has been contracted to provide the following advisory contract renewal [15(c)] materials. The report contained herein was specifically designed to provide boards of directors/trustees the necessary fee, expense, and investment performance information to help fulfill their advisory contract review responsibilities under Section 15(c) of the Investment Company Act of 1940 ('40 Act). As the leading firm comprehensively covering the fund business, Lipper is in a unique position to furnish detailed comparative data allowing boards and advisors to assess a fund's fee and performance position relative to the overall market.

Comparative data shown in the report typically include contractual and actual management fees, operating expense components, and total return performance. These data items, considered together, may indicate the effectiveness of the manager in operating the investment company(ies) that is (are) the topic of this report. The data provided are primarily for directly comparable business segments, yet are supplemented by data encompassing broader benchmarks. The board is required to request of the advisor such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment advisor of an investment company. Subsequently, the board must evaluate the terms of the contract given the information provided and any

additional data judged as aiding the review process. The board has fulfilled a significant portion of its legal obligation by requesting and thoroughly reviewing this Lipper report.

Section 15(c) of the '40 Act

Section 15(c) of the '40 Act requires an annual in-person meeting of an investment company's board of directors/trustees to evaluate the terms and conditions of an advisory contract and approve a new contract or renew the existing contract. A contract's approval or renewal requires the affirmative vote of a majority of the full board as well as the affirmative vote of a majority of the independent directors/ trustees. The board's review of the contract is to determine if the level of the fee being remitted to the advisor for services provided is reasonable and fair. In Lipper's view, this is accomplished most effectively by using only relevant, and sometimes small, segments of the investment company business.

Obligations Under Section 15(c)

In determining the reasonableness of an advisory fee, the board is required – as explicitly stipulated by Section15(c) of the '40 Act or as interpreted by prominent investment company counsel – to assess with a high degree of inquiry, knowledge, and critical judgement the:

- Adequacy and applicability of the information provided to the board by the advisor aiding the decision to approve and/or negotiate the advisory agreement
- Level of fees to which the advisor is entitled under the terms and conditions of the advisory contract (excluding waivers or reimbursements)

- Advisory fee level compared to other similar investment accounts managed by the advisor
- Level of total operating expenses viewed in the context of an appropriate fund business segment
- Annualized and/or cumulative investment performance compared to funds with a similar investment objective covering a ten-year period or since the fund's inception, if shorter than ten years
- Portfolio management-related statistics such as portfolio turnover and brokerage commission expenses
- Nature and scope of the services provided by the advisor to the fund
- Quality of the services provided by the advisor and affiliates
- Resource adequacy and profitability of the advisor
- Compensation paid by the fund to affiliates of the advisor
- Total amount of other related benefits accrued to shareholders
- Existence of economies of scale and the resulting amount of monetary gain realized by shareholders
- Overall balance of shareholder benefits versus advisor benefits
- Available alternatives while not losing sight of total shareholder cost in potentially ratifying a contract with a different advisor

Note: Most business participants view advisor replacement as drastic and not practical in most instances.

Each of these factors should be evaluated using the duties of care and loyalty under state and federal law.

Legal Precedents

From a legal perspective and in line with court decisions, directors/trustees should be aware that a fee that is not the result of arms-length bargaining may be interpreted as *not* in the best interest of fund shareholders. The most visible and well-known fee-related court case is *Gartenberg vs. Merrill Lynch Asset Management, Inc. (1982).* Aside from the critical review factors cited above, the following are additional factors that have emerged from court cases in determining an advisory fee's reasonableness:

- A fee must *not* be so disproportionately large that it bears no reasonable relationship to the services rendered.
- Securing the lowest fee possible through potentially damaging negotiations is not the goal of the board.
- A high level of profit realized by the advisor is not, in and of itself, necessarily indicative of an "excessive" fee.

Lipper's Role

Lipper views its role in the advisory contract renewal process as generally nonconsultative. The subject matter contained herein is not intended to reflect a biased view and – at the very least – is intended to simultaneously meet minimum content requirements of the board, advisor, and legal counsel. The material's purpose is to provide an unbiased view of the subject fund's(s') relative position regarding levels of fees, expenses, and total return performance. Lipper

does not attempt to measure or assess levels of service or the general quality of services rendered.

The staff of the Board Analysis Services Group at Lipper is available to supplement the information that follows (upon request) and to answer any questions that may arise during review of the report. We welcome any suggestions for content or format enhancements. We trust the board will find the information to be useful in evaluating the advisory contract(s) and look forward to serving your 15(c) needs in the future.

Lipper Credentials

Facts About Lipper

- Lipper is commissioned by many of the largest fund groups to provide packages of investment company analyses for the purpose of advisory contract renewal. Clients encompass over 2,700 funds (portfolios) representing approximately 32% of total open-end fund assets.
- Lipper has offices in: New York; Denver, CO; London; and Hong Kong.
- Lipper is the most highly regarded provider of data and analysis to mutual fund boards and institutions sponsoring investment companies.
- Lipper provides financial data to major institutions, money managers, and investment advisors throughout the world.
- Lipper is known for its extensive data on offshore funds, open-end funds, closed-end funds, and funds underlying variable annuity/life insurance contracts.

- Lipper has data going back to 1959. We currently track the investment performance of over 34,000 U.S. registered funds worldwide with assets in excess of US $7.2 trillion.
- In the United States, our clients include fund management firms that sponsor 96% of the investment company business's total assets or in excess of US $3.5 trillion. Elsewhere in the world, our clients include the largest fund management groups, which manage offshore and international investment funds worldwide.

The Lipper Advantage

Experience

- Lipper has a long history – over 15 years – in the 15(c) business.
- Lipper is familiar with the unique needs of individual boards.
- We have more than 35 professionals dedicated to the creation of 15(c) reports.

Objectivity

- Lipper has no affiliation with advisors, administrators, or legal counsel.
- Our 15(c) methodology is proven and time-tested.
- Our professional staff is available to attend board meetings.

Accuracy

- Our expense data are derived directly from audited annual reports, unless noted otherwise. Expense allocation among classes of shares ensures highly accurate data.

- Performance data are downloaded directly from the NASD and fund companies and are checked daily for accuracy and coverage.
- We perform a wide series of quality checks on all data elements. Our data integrity, accuracy, and validity ensure confidence and mitigate potential embarrassment.

Authority

- Lipper's 15(c) reports are court-tested and proven. They have been introduced by fund companies as a defense in litigation, and a consistent record of defendant victories has been established.
- The *Wall Street Journal*, *Barron's*, and the *Associated Press*, among others, rely on Lipper for accurate, up-to-date investment company data.

Electronic Delivery

- Lipper can provide multimedia presentations on compact disc utilizing Adobe Acrobat or Microsoft Powerpoint, and we provide support through our website: ***www.lipperweb.com***

Introduction

Our goal in preparing this report is to provide a package of fund analysis that is informative and comprehensive as well as organized and readable for the user. With this objective in mind, we typically design each Lipper 15(c) report to include the following seven sections:

- Fund Summary
- Expense Comparisons
- Performance Comparisons
- Supporting Data Tables

- Methodology
- Glossary of Terms
- Investment Classifications/Objectives

Fund Summary

The Fund Summary at the beginning of each fund report provides the rankings and quintile positions of the subject fund within an Expense Group and Expense Universe, as applicable. An Expense Group is a small, hand-selected group of "peer funds," while an Expense Universe encompasses a broader array of funds.

Expense Rankings and Quintiles

	Rank in Expense Group	Expense Group Quintile	Rank in Expense Universe	Expense Universe Quintile
Contractual Management Fees	2/14	1st	—	—
Total Expenses Including 12b-1/non-12b-1 Services Fees	1/14	1st	2/44	1st
Total Expenses Excluding 12b-1/non-12b-1 Services Fees	2/14	1st	2/44	1st
Management Fees	2/14	1st	2/44	1st
Nonmanagement Expenses	6/14	2nd	11/45	2nd
Actual 12b-1/non-12b-1 Service Fees	2/13	1st	—	—
Allowable 12b-1/non-12b-1 Service Fees	12/13	5th	—	—
Brokerage Commissions	7/13	3rd	—	—
Portfolio Turnover Rates	5/13	2nd	15/45	2nd

Our ranking methodology is as follows:

Lowest Expenses

Best Ranking (e.g., 1/15) <

Highest Performance

The Fund Summary also includes a brief description of the characteristics of each group and universe, including the number of funds in the group, the asset range, and the investment classification/objective.

Funds in the Expense Group and Expense Universe are selected by Lipper in accordance with our standard Methodology, a copy of which is included at the back of each report volume. Typically, any special requests or modifications to the standard selection criteria are disclosed at the end of the Methodology.

The Methodology also provides a detailed explanation of the selection process for each group and universe included in the report.

Expense Comparisons

A Lipper 15(c) report may provide a number of different expense comparisons, including:

- Contractual management fees
- Actual total expenses
- Actual management fees
- Actual nonmanagement expenses
- Actual and allowable 12b-1/non-12b-1 service fees
- Fee waivers/expense reimbursements

Each of these six expense-related items may be illustrated in various forms. A floating bar chart depict-

ing the Expense Universe is typically provided for each of these comparisons with the exception of the contractual management fee chart and the actual and allowable 12b-1/non-12b-1 service fee charts. In each of the charts, *fees and expenses are illustrated net of any fee waivers or expense reimbursements.* The chart illustrating total expenses shows any waivers and/or reimbursements as a dashed gray-outlined white rectangle at the end of the horizontal bar. This representation may help users of this report to quickly assess the frequency and magnitude of waivers and/or reimbursements in the Expense Group. Throughout the report, each expense component is represented in the charts by the same color or shade, whether presented in color or black and white. This consistent color/shading convention is used to enable quick recognition of expense components throughout the reports. In color reports, the subject fund (or the classes of shares) will usually be maroon in all graphic representations.

Note: "Contractual Management Fees" are distinct from "Management Fees" in that the former are based on fee schedules (including any applicable breakpoints) that are computed for hypothetical, common levels of portfolio total net assets. The latter are expenses actually incurred by the fund for management over the latest fiscal period and include credits for any waivers or reimbursements.

Performance Comparisons

Contract renewal meetings of investment company boards of directors/trustees often center around total return performance. Specifics surrounding the individual performance of the subject fund and how it

compares to a representative group of funds and a benchmark index are crucial for the board to most effectively evaluate the subject fund's performance. The Lipper 15(c) report serves this need by providing the total return performance of the subject fund, its ranking within both the Performance Group and Performance Universe, and its position relative to an appropriate Lipper index.

Specifically, annualized total return performance for one-, two-, three-, four-, five-, and ten-year periods (as applicable) is illustrated for both the group and the universe. The median for each period and the performance of the subject fund are plotted in floating bars whose (vertical) length represents the range of data. Quintiles and standard deviation are also provided for each performance period. Although not plotted on the chart, these figures provide users of the report valuable information about the "distribution" of funds within the range. In other words, are the performance figures tightly grouped around a common value or are they wide-spread? In some reports, an appropriate Lipper index is included as an additional benchmark for performance.

Supporting Data Tables

Supporting data tables are provided and are generally found after the performance section of each fund's report. Each table is designed to highlight a specific piece of information for each fund in the Expense and Performance Groups.

Methodology

A copy of the Lipper 15(c) Methodology is included at the end of each report book. Reviewing the Methodology prior to reading the fund reports is recommended. Unless noted in the Special Requests sec-

tion of the Methodology or described in the fund report itself, each fund report follows the procedures as outlined in the Methodology.

Feedback

Comments from users of this report regarding content and format are always welcome. Lipper continually strives to improve the presentation of our 15(c) package and encourages reader feedback. Please direct any feedback to:

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kip.price@lipper.reuters.com
jonathan.hale@lipper.reuters.com

EXHIBIT 11

Confidential Report to Trustees

Harris Associates Investment Trust

June 6, 2003

Leading Fund Intelligence

Lipper Inc.

Advisory Contract Renewal Reporting
Pursuant to Section 15(c) of the
Investment Company Act of 1940

http://www.lipperweb.com
http://www.lipperleaders.com

[Copyright Page and Table of Contents Omitted]

Report Background

Lipper and Contract Renewal

Lipper Inc. ("Lipper"), an independent provider of investment company data, has been contracted to provide the following advisory contract renewal [15(c)] materials. The report contained herein was specifically designed to provide boards of directors/trustees the necessary fee, expense, and investment performance information to help fulfill their advisory contract review responsibilities under Section 15(c) of the Investment Company Act of 1940 ('40 Act). As the leading firm comprehensively covering the fund business, Lipper is in a unique position to furnish detailed comparative data allowing boards and advisors to assess a fund's fee and performance position relative to the overall market.

Comparative data shown in the report typically include contractual and actual management fees, operating expense components, and total return performance. These data items, considered together, may indicate the effectiveness of the manager in operating the investment company(ies) that is (are) the topic of this report. The data provided are primarily for directly comparable business segments, yet are supplemented by data encompassing broader benchmarks. The board is required to request of the advisor such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment advisor of an investment company. Subsequently, the board must evaluate the terms of the contract given the information provided and any

additional data judged as aiding the review process. The board has fulfilled a significant portion of its legal obligation by requesting and thoroughly reviewing this Lipper report.

Section 15(c) of the '40 Act

Section 15(c) of the '40 Act requires an annual in-person meeting of an investment company's board of directors/trustees to evaluate the terms and conditions of an advisory contract and approve a new contract or renew the existing contract. A contract's approval or renewal requires the affirmative vote of a majority of the full board as well as the affirmative vote of a majority of the independent directors/trustees. The board's review of the contract is to determine if the level of the fee being remitted to the advisor for services provided is reasonable and fair. In Lipper's view, this is accomplished most effectively by using only relevant, and sometimes small, segments of the investment company business.

Obligations Under Section 15(c)

In determining the reasonableness of an advisory fee, the board is required – as explicitly stipulated by Section 15(c) of the '40 Act or as interpreted by prominent investment company counsel – to assess with a high degree of inquiry, knowledge, and critical judgement the:

- Adequacy and applicability of the information provided to the board by the advisor aiding the decision to approve and/or negotiate the advisory agreement
- Level of fees to which the advisor is entitled under the terms and conditions of the advisory contract (excluding waivers or reimbursements)

- Advisory fee level compared to other similar investment accounts managed by the advisor
- Level of total operating expenses viewed in the context of an appropriate fund business segment
- Annualized and/or cumulative investment performance compared to funds with a similar investment objective covering a ten-year period or since the fund's inception, if shorter than ten years
- Portfolio management-related statistics such as portfolio turnover and brokerage commission expenses
- Nature and scope of the services provided by the advisor to the fund
- Quality of the services provided by the advisor and affiliates
- Resource adequacy and profitability of the advisor
- Compensation paid by the fund to affiliates of the advisor
- Total amount of other related benefits accrued to shareholders
- Existence of economies of scale and the resulting amount of monetary gain realized by shareholders
- Overall balance of shareholder benefits versus advisor benefits
- Available alternatives while not losing sight of total shareholder cost in potentially ratifying a contract with a different advisor

Note: Most business participants view advisor replacement as drastic and not practical in most instances.

Each of these factors should be evaluated using the duties of care and loyalty under state and federal law.

Legal Precedents

From a legal perspective and in line with court decisions, directors/trustees should be aware that a fee that is not the result of arms-length bargaining may be interpreted as *not* in the best interest of fund shareholders. The most visible and well-known fee-related court case is *Gartenberg vs. Merrill Lynch Asset Management, Inc. (1982).* Aside from the critical review factors cited above, the following are additional factors that have emerged from court cases in determining an advisory fee's reasonableness:

- A fee must *not* be so disproportionately large that it bears no reasonable relationship to the services rendered.
- Securing the lowest fee possible through potentially damaging negotiations is not the goal of the board.
- A high level of profit realized by the advisor is not, in and of itself, necessarily indicative of an "excessive" fee.

Contract Renewal Rationale

Effective in early 2002, the SEC now requires that boards of directors/trustees explain the reasoning used when an investment company advisory contract is renewed. The explanation must be disclosed in Part B of the N-1A filing (Statement of Additional Information [SAI]) under the broad heading "Investment Management." A distinct subheading similar to "Board Review of Investment Advisory Agreements" may be viewed as optimal. Presumably, adherence to

the disclosure requirement is most effectively accomplished by the board members personally with assistance from legal counsel.

The SEC mandate states that the board must outline the factors considered prior to a fund contract being renewed. In essence, the explicit rationale used to justify the renewal or ratification of an advisory contract must be stated in plain English for shareholders to read in the SAI. In line with Section 15(c), review of the factors must result in board determination that a contract is fair and reasonable. Apparent interpretation of the regulation has been diverse and disclosure has varied widely to date. Some or all of the enclosed Lipper analysis may be disaggregated and each type of data cited as a factor considered.

> **Note:** The SEC has commented that "boilerplate" language across all funds in a complex is not acceptable. Furthermore, a canned "laundry list" of widely accepted 15(c) review points for all funds is also not considered sufficient disclosure.

Lipper's Role

Lipper views its role in the advisory contract renewal process as generally nonconsultative. The subject matter contained herein is not intended to reflect a biased view and – at the very least – is intended to simultaneously meet minimum content requirements of the board, advisor, and legal counsel. The material's purpose is to provide an unbiased view of the subject fund's(s') relative position regarding levels of fees, expenses, and total return performance. Lipper does not attempt to measure or assess levels of service or the general quality of services rendered.

The staff of the Board Analysis Services Group at Lipper is available to supplement the information that follows (upon request) and to answer any questions that may arise during review of the report. We welcome any suggestions for content or format enhancements. We trust the board will find the information to be useful in evaluating the advisory contract(s) and look forward to serving your 15(c) needs in the future.

Lipper Credentials

Facts About Lipper

- Lipper is commissioned by many of the largest fund groups to provide packages of investment company analyses for the purpose of advisory contract renewal. Clients encompass over 2,700 funds (portfolios) representing approximately 32% of total open-end fund assets.
- Lipper has offices in: New York; Denver, CO; London; and Hong Kong.
- Lipper is the most highly regarded provider of data and analysis to mutual fund boards and institutions sponsoring investment companies.
- Lipper provides financial data to major institutions, money managers, and investment advisors throughout the world.
- Lipper is known for its extensive data on offshore funds, open-end funds, closed-end funds, and funds underlying variable annuity/life insurance contracts.
- Lipper has data going back to 1959. We currently track the investment performance of over 37,500

U.S. registered funds worldwide with assets in excess of US $6.8 trillion.

- In the United States, our clients include fund management firms that sponsor 96% of the investment company business's total assets or in excess of US $3.5 trillion. Elsewhere in the world, our clients include the largest fund management groups, which manage offshore and international investment funds worldwide.

The Lipper Advantage

Experience

- Lipper has a long history – over 15 years – in the 15(c) business.
- Lipper is familiar with the unique needs of individual boards.
- We have more than 35 professionals dedicated to the creation of 15(c) reports.

Objectivity

- Lipper has no affiliation with advisors, administrators, or legal counsel.
- Our 15(c) methodology is proven and time-tested.
- Our professional staff is available to attend board meetings.

Accuracy

- Our expense data are derived directly from audited annual reports, unless noted otherwise. Expense allocation among classes of shares ensures highly accurate data.

- Performance data are downloaded directly from the NASD and fund companies and are checked daily for accuracy and coverage.
- We perform a wide series of quality checks on all data elements. Our data integrity, accuracy, and validity ensure confidence and mitigate potential embarrassment.

Authority

- Lipper's 15(c) reports are court-tested and proven. They have been introduced by fund companies as a defense in litigation, and a consistent record of defendant victories has been established.
- The *Wall Street Journal*, *Barron's*, and the *Associated Press*, among others, rely on Lipper for accurate, up-to-date investment company data.

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Expense Rankings and Quintiles

	Rank in Expense Group	Expense Group Quintile	Rank in Expense Universe	Expense Universe Quintile
Contractual Management Fees	2/14	1st	—	—
Total Expenses Including 12b-1/non-12b-1 Services Fees	1/14	1st	2/44	1st
Total Expenses Excluding 12b-1/non-12b-1 Services Fees	2/14	1st	2/44	1st
Management Fees	2/14	1st	2/44	1st
Nonmanagement Expenses	6/14	2nd	11/45	2nd
Actual 12b-1/non-12b-1 Service Fees	2/13	1st	—	—
Allowable 12b-1/non-12b-1 Service Fees	12/13	5th	—	—
Brokerage Commissions	7/13	3rd	—	—
Portfolio Turnover Rates	5/13	2nd	15/45	2nd

Our ranking methodology is as follows:

Lowest Expenses (1)

Best Ranking (e.g., 1/15) <

Highest Performance (15)

The Fund Summary also includes a brief description of the characteristics of each group and universe, including the number of funds in the group, the asset range, and the investment classification/objective.

Funds in the Expense Group and Expense Universe are selected by Lipper in accordance with our standard Methodology, a copy of which is included at the back of each report volume. Typically, any special requests or modifications to the standard selection criteria are disclosed at the end of the Methodology.

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- Actual total expenses
- Actual management fees
- Actual nonmanagement expenses
- Actual and allowable 12b-1/non-12b-1 service fees
- Fee waivers/expense reimbursements

Each of these six expense-related items may be illustrated in various forms. A floating bar chart depict-

ing the Expense Universe is typically provided for each of these comparisons with the exception of the contractual management fee chart and the actual and allowable 12b-1/non-12b-1 service fee charts. In each of the charts, *fees and expenses are illustrated net of any fee waivers or expense reimbursements.* The chart illustrating total expenses shows any waivers and/or reimbursements as a dashed gray-outlined white rectangle at the end of the horizontal bar. This representation may help users of this report to quickly assess the frequency and magnitude of waivers and/or reimbursements in the Expense Group. Throughout the report, each expense component is represented in the charts by the same color or shade, whether presented in color or black and white. This consistent color/shading convention is used to enable quick recognition of expense components throughout the reports. In color reports, the subject fund (or the classes of shares) will usually be maroon in all graphic representations.

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Contract renewal meetings of investment company boards of directors/trustees often center around total return performance. Specifics surrounding the individual performance of the subject fund and how it

compares to a representative group of funds and a benchmark index are crucial for the board to most effectively evaluate the subject fund's performance. The Lipper 15(c) report serves this need by providing the total return performance of the subject fund, its ranking within both the Performance Group and Performance Universe, and its position relative to an appropriate Lipper index.

Specifically, annualized total return performance for one-, three-, and five-year periods (as applicable) is illustrated for both the group and the universe. The median for each period and the performance of the subject fund are plotted in floating bars whose (vertical) length represents the range of data. Quintiles and standard deviation are also provided for each performance period. Although not plotted on the chart, these figures provide users of the report valuable information about the "distribution" of funds within the range. In other words, are the performance figures tightly grouped around a common value or are they wide-spread? In some reports, an appropriate Lipper index is included as an additional benchmark for performance.

Performance Rankings and Quintiles

	Rank in Performance Group	Performance Group Quintile	Rank in Performance Universe	Performance Universe Quintile
Total Return (Annualized) for Periods Ended 07/31/02				
One Year	1/13	1st	18/284	1st
Three Years	5/13	2nd	80/213	2nd
Five Years	1/12	1st	4/127	1st

Our ranking methodology is as follows:

Highest Performance (1)

Ranking (e.g., 1/15) <

Lowest Performance (15)

Supporting Data Tables

Supporting data tables are provided and are generally found after the performance section of each fund's report. Each table is designed to highlight a specific piece of information for each fund in the Expense and Performance Groups.

Methodology

A copy of the Lipper 15(c) Methodology is included at the end of each report book. Reviewing the Methodology prior to reading the fund reports is recommended. Unless noted in the Special Requests section of the Methodology or described in the fund report itself, each fund report follows the procedures as outlined in the Methodology.

Designation Images

Expense Group

Expense Universe

Upper Investment Classification/Objective

Subject Fund

Performance Group

Performance Universe

Feedback

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EXHIBIT 12

Harris Associates Investment Trust

May 25, 2004

Leading Fund Intelligence

Lipper Inc.

Advisory Contract Renewal Reporting
Pursuant to Section 15(c) of the
Investment Company Act of 1940

http://www.lipperweb.com
http://www.lipperleaders.com

[Copyright Page and Table of Contents Omitted]

Report Background

Lipper and Contract Renewal

Lipper Inc. ("Lipper"), an independent provider of investment company data, has been contracted to provide the following advisory contract renewal [15(c)] materials. The report contained herein was specifically designed to provide boards of directors/trustees the necessary fee, expense, and investment performance information to help fulfill their advisory contract review responsibilities under Section 15(c) of the Investment Company Act of 1940 ('40 Act). As the leading firm comprehensively covering the fund business, Lipper is in a unique position to furnish detailed comparative data allowing boards and advisors to assess a fund's fee and performance position relative to the overall market.

Comparative data shown in the report typically include contractual and actual management fees, operating expense components, and total return performance. These data items, considered together, may indicate the effectiveness of the manager in operating the investment company(ies) that is (are) the topic of this report. The data provided are primarily for directly comparable business segments, yet are supplemented by data encompassing broader benchmarks. The board is required to request of the advisor such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment advisor of an investment company. Subsequently, the board must evaluate the terms of the contract given the information provided and any

additional data judged as aiding the review process. The board has fulfilled a significant portion of its legal obligation by requesting and thoroughly reviewing this Lipper report.

Consideration of Separate Accounts

Lipper's 15(c) analysis only considers Investment Company Act of 1940-registered funds and does not consider separate investment accounts managed by the advisor. We are neither privy to the existence of other accounts, nor the fees associated with any additional accounts managed by the advisor. In the event we may be made aware of other similar accounts, their existence or fee levels played no role in the peer selection process.

Section 15(c) of the '40 Act

Section 15(c) of the '40 Act requires an annual in-person meeting of an investment company's board of directors/trustees to evaluate the terms and conditions of an advisory contract and approve a new contract or renew the existing contract. A contract's approval or renewal requires the affirmative vote of a majority of the full board as well as the affirmative vote of a majority of the independent directors/trustees. The board's review of the contract is to determine if the level of the fee being remitted to the advisor for services provided is reasonable and fair. In Lipper's view, this is accomplished most effectively by using only relevant, and sometimes small, segments of the investment company business.

Obligations Under Section 15(c)

In determining the reasonableness of an advisory fee, the board is required – as explicitly stipulated by Section15(c) of the '40 Act or as interpreted by promi-

nent investment company counsel – to assess with a high degree of inquiry, knowledge, and critical judgement the:

- Adequacy and applicability of the information provided to the board by the advisor aiding the decision to approve and/or negotiate the advisory agreement
- Level of fees to which the advisor is entitled under the terms and conditions of the advisory contract (excluding waivers or reimbursements)
- Advisory fee level compared to other similar investment accounts managed by the advisor. [This is not provided in Lipper's 15(c) analysis. See heading "Consideration of Separate Accounts."]
- Level of total operating expenses viewed in the context of an appropriate fund business segment
- Annualized and/or cumulative investment performance compared to funds with a similar investment objective covering a ten-year period or since the fund's inception, if shorter than ten years
- Portfolio management-related statistics such as portfolio turnover and brokerage commission expenses
- Nature and scope of the services provided by the advisor to the fund
- Quality of the services provided by the advisor and affiliates
- Resource adequacy and profitability of the advisor
- Compensation paid by the fund to affiliates of the advisor

- Total amount of other related benefits accrued to shareholders
- Existence of economies of scale and the resulting amount of monetary gain realized by shareholders
- Overall balance of shareholder benefits versus advisor benefits
- Available alternatives while not losing sight of total shareholder cost in potentially ratifying a contract with a different advisor

> **Note:** Most business participants view advisor replacement as drastic and not practical in most instances.

Each of these factors should be evaluated using the duties of care and loyalty under state and federal law.

Legal Precedents

From a legal perspective and in line with court decisions, directors/trustees should be aware that a fee that is not the result of arms-length bargaining may be interpreted as *not* in the best interest of fund shareholders. The most visible and well-known fee-related court case is *Gartenberg vs. Merrill Lynch Asset Management, Inc. (1982).* Aside from the critical review factors cited above, the following are additional factors that have emerged from court cases in determining an advisory fee's reasonableness:

- A fee must *not* be so disproportionately large that it bears no reasonable relationship to the services rendered.

- Securing the lowest fee possible through potentially damaging negotiations is not the goal of the board.
- A high level of profit realized by the advisor is not, in and of itself, necessarily indicative of an "excessive" fee.

Contract Renewal Rationale

Effective in early 2002, the SEC now requires that boards of directors/trustees explain the reasoning used when an investment company advisory contract is renewed. The explanation must be disclosed in Part B of the N-1A filing (Statement of Additional Information [SAI]) under the broad heading "Investment Management." A distinct subheading similar to "Board Review of Investment Advisory Agreements" may be viewed as optimal. Presumably, adherence to the disclosure requirement is most effectively accomplished by the board members personally with assistance from legal counsel.

The SEC mandate states that the board must outline the factors considered prior to a fund contract being renewed. In essence, the explicit rationale used to justify the renewal or ratification of an advisory contract must be stated in plain English for shareholders to read in the SAI. In line with Section 15(c), review of the factors must result in board determination that a contract is fair and reasonable. Apparent interpretation of the regulation has been diverse and disclosure has varied widely to date. Some or all of the enclosed Lipper analysis may be disaggregated and each type of data cited as a factor considered.

Note: The SEC has commented that "boilerplate" language across all funds in a complex is not acceptable. Furthermore, a canned "laundry list" of widely accepted 15(c) review points for all funds is also not considered sufficient disclosure.

Lipper's Role

Lipper views its role in the advisory contract renewal process as generally nonconsultative. The subject matter contained herein is not intended to reflect a biased view and – at the very least – is intended to simultaneously meet minimum content requirements of the board, advisor, and legal counsel. The material's purpose is to provide an unbiased view of the subject fund's(s') relative position regarding levels of fees, expenses, and total return performance. Lipper does not attempt to measure or assess levels of service or the general quality of services rendered.

The staff of the Global Fiduciary Review (GFR) unit at Lipper is available to supplement the information that follows (upon request) and to answer any questions that may arise during review of the report. We welcome any suggestions for content or format enhancements. GFR trusts each board will find the information to be useful in evaluating the advisory contract(s) and looks forward to serving the business's 15(c) needs in the future.

Lipper Credentials

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funds (portfolios) representing approximately 35% of total open-end fund assets.

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- Lipper is the most highly regarded provider of data and analysis to mutual fund boards and institutions sponsoring investment companies.
- Lipper provides financial data to major institutions, money managers, and investment advisors throughout the world.
- Lipper is known for its extensive data on offshore funds, open-end funds, closed-end funds, and funds underlying variable annuity/life insurance contracts.
- Lipper has data going back to 1959. We currently track the investment performance of over 40,000 U.S. registered funds worldwide with assets in excess of US $7.4 trillion.
- In the United States, our clients include fund management firms that sponsor 96% of the investment company business's total assets or in excess of US $7.1 trillion. Elsewhere in the world, our clients include the largest fund management groups, which manage offshore and international investment funds worldwide.

The Lipper Advantage

Experience

- Lipper has a long history – over 17 years – in the 15(c) business.
- Lipper is familiar with the unique needs of individual boards.

- We have more than 25 professionals focused solely on the creation of 15(c) reports.

Objectivity

- Lipper has no affiliation with advisors, administrators, or legal counsel.
- Our 15(c) methodology is proven and time-tested.
- Our professional staff is available to attend board meetings.

Accuracy

- Our expense data are derived directly from audited annual reports, unless noted otherwise. Manual expense allocation among classes of shares ensures highly accurate data.
- Performance data are downloaded directly from the NASD and fund companies and are checked daily for accuracy and coverage.
- We perform a wide series of quality checks on all data elements. Our data integrity, accuracy, and validity ensure confidence and mitigate potential embarrassment.

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- Lipper's 15(c) reports are court-tested and proven. They have been introduced by fund companies as evidence (exhibits) in litigation, and a consistent record of defendant victories has been established.
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Fund Summary

A Fund Summary, typically at the beginning of each fund report, provides rankings and quintile positions of a subject fund within an expense group, expense universe, performance group, and performance universe, as applicable. An expense group is a small, hand-selected group of "peer funds," while an expense universe encompasses a broader array of funds. A performance group is derived from the expense group, while the performance universe is all of the funds within a subject fund's investment classification/objective.

The following are examples of expense and performance fund summaries and our ranking methodology:

Expense Rankings and Quintiles

	Rank in Expense Group	Expense Group Quintile	Rank in Expense Universe	Expense Universe Quintile
Contractual Management Fees	2/14	1st	—	—
Total Expenses Including 12b-1/non-12b-1 Services Fees	1/14	1st	2/44	1st
Total Expenses Excluding 12b-1/non-12b-1 Services Fees	2/14	1st	2/44	1st
Management Fees	2/14	1st	2/44	1st
Nonmanagement Expenses	6/14	2nd	11/45	2nd
Actual 12b-1/non-12b-1 Service Fees	2/13	1st	—	—
Allowable 12b-1/non-12b-1 Service Fees	12/13	5th	—	—
Brokerage Commissions	7/13	3rd	—	—
Portfolio Turnover Rates	5/13	2nd	15/45	2nd

For expenses, our ranking methodology is as follows:

Ranking $<$ Lowest Expenses (Rank = 1)

Highest Expenses (Rank = 15)

Performance Rankings and Quintiles

	Rank in Performance Group	Performance Group Quintile	Rank in Performance Universe	Performance Universe Quintile
Total Return (Annualized) for Periods Ended 07/31/02				
One Year	1/13	1st	18/284	1st
Three Years	5/13	2nd	80/213	2nd
Five Years	1/12	1st	4/127	1st

For performance, our ranking methodology is as follows:

Ranking < Highest Performance (Rank = 1)

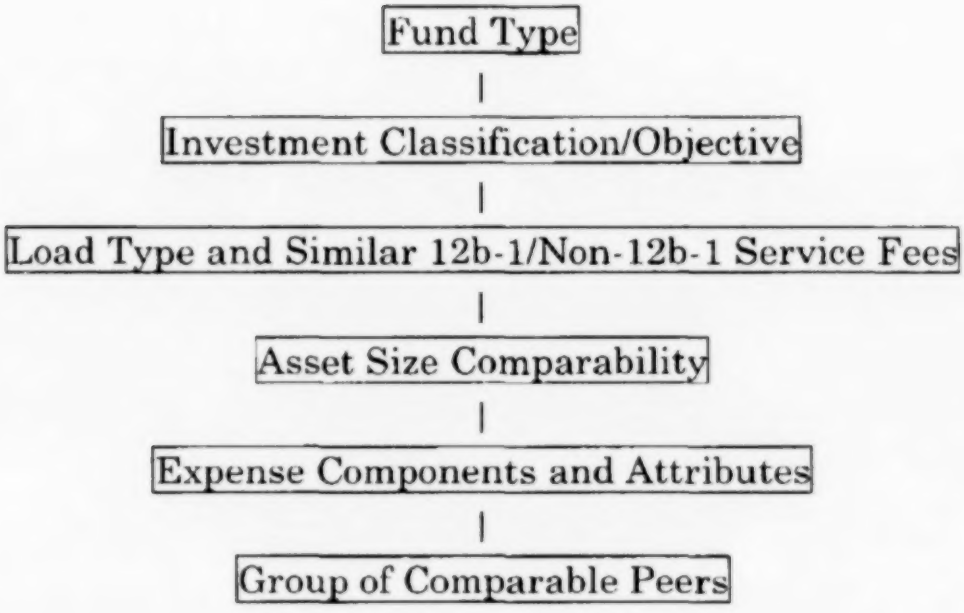
Lowest Performance (Rank = 15)

The Fund Summary also includes a brief description of the characteristics of each group and universe, including the number of funds in the group, the asset range, and the investment classification/objective.

Funds in the expense group and expense universe are selected by Lipper in accordance with our standard Methodology, a copy of which is included at the back of each report volume. Typically, any client requests or modifications to the standard selection criteria are disclosed at the end of the Methodology.

Expense Comparisons

One of the core components of a 15(c) report is expense group peer selection. The following is a very brief introduction to Lipper's expense group peer selection methodology:



Using the expense groups as underlying data, a Lipper 15(c) report may provide a number of different expense comparisons, including:

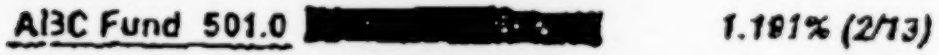
- Contractual management fees
- Actual total expenses
- Actual management fees
- Actual nonmanagement expenses
- Actual and allowable 12b-1/non-12b-1 service fees
- Fee waivers/expense reimbursements

Each at these six expense-related items may be illustrated in various forms. A floating bar chart depicting the expense universe is typically provided for each of these comparisons with the exception of the contractual management fee chart and the actual and allowable 12b-1/non-12b-1 service fee charts. In each of the charts, *fees and expenses are illustrated net of any fee waivers or expense reimbursements.* The chart illustrating total expenses shows any

waivers and/or reimbursements as a dashed gray-outlined (white) rectangle at the end of the horizontal bar. This representation may help users of this report to quickly assess the frequency and magnitude of waivers and/or reimbursements in the expense group. Consistent color/shading conventions are used to enable quick recognition of expense components throughout the reports. The subject fund (or classes of shares) will usually be maroon in all graphic representations.

> **Note:** "Contractual Management Fees" are distinct from "Management Fees" in that the former are based on fee schedules (including any applicable breakpoints) that are computed for hypothetical, common levels of portfolio total net assets. The latter are expenses actually incurred by the fund for management (advisory + administrator) over the latest fiscal period and include reductions for any waivers or reimbursements.

Ranks for the subject fund may be displayed in different formats depending on the type of expense chart.



In the above example, the subject fund's name and the fund's portfolio average net assets are underlined by a dark red line. The fund's total expenses (1.191%) are displayed at the end of the bar, followed by the fund's rank. In this example, the fund ranks second out of 13 funds in the expense group.

Another format Lipper uses to display a fund's rank is shown at the right. The fund's total expenses (1.191%) are shown at the top of the vertical bar and the fund ranks second out of 13 funds in the expense group.

Performance Comparisons

Contract renewal meetings of investment company boards of directors/trustees may center around the topic of total return performance. Specifics surrounding the individual performance of a subject fund and how it compares to a representative group of funds and a benchmark index are crucial for the board to most effectively evaluate the subject fund's performance. The Lipper 15(c) report serves this need by providing the total return performance of a subject fund, its ranking within both the performance group and performance universe, and its position relative to an appropriate Lipper index.

Specifically, annualized total return performance for one-, three-, and five-year periods (as applicable) is illustrated for both the performance group and the performance universe. The median for each period and the performance of a subject fund are plotted in floating bars whose (vertical) length represents the range of data. Quintiles and standard deviation are also provided for each performance period. Although not plotted on the chart, these figures provide users of the report valuable information about the "distribution" of funds within the range. In other words, are the performance figures tightly grouped around

a common value or are they wide-spread? In some reports, an appropriate Lipper index is included as an additional benchmark for performance.

Ranks for a subject fund may be displayed in different formats depending on the type of performance chart. In the example at the right, the fund ranks 112th out of 136 funds in the performance universe.

Supporting Data Tables

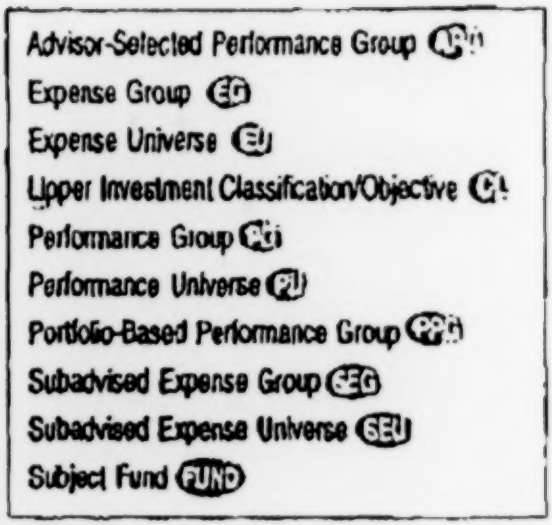
Supporting data tables are provided for readers who desire detail and are generally found after the last section of each fund's report. Each table is designed to highlight a specific piece of information for each fund in the expense and performance groups.

Methodology

A copy of the Lipper 15(c) Methodology is included at the end of each report book. Reviewing the Methodology prior to reading the individual fund reports is recommended. Unless noted in the Client Requests section of the Methodology or described in the fund report itself, each fund report follows the procedures as outlined in the Methodology.

Designation Images

"Designation images" included in each report allow the reader to quickly identity which group and/or universe is the subject of each chart. The groups and universes and, therefore, the designation images may vary by type of report. The following is a key for the images and their respective group or universe:



Feedback

Comments from readers of this report regarding content and format are always welcome. Lipper continually strives to improve the breadth and presentation of our 15(c) package and encourages reader feedback. Please direct any feedback to:

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Executive Summary—Expenses

The following quintile summary is designed to encapsulate the Harris Associates Investment Trust's relative expense and performance rankings in an easy-to-read brief format. Those funds displaying dark blue boxes rank in the middle range of the peer group while those with orange boxes are more on the periphery. The orange boxes identify "outlying values," whether favorable or unfavorable.

> **Note:** See Expense Quintiles or Performance Quintiles headings below for a description of quintile computations.

On the top of each page is a key for each quintile summary presented. Each quintile is represented by a colored "quintile box." The first (1st) and fifth (5th) quintiles are represented by orange, and the second (2nd), third (3rd), and fourth (4th) quintiles are represented by dark blue.

The first column of the Expense Group quintile summary represents contractual management fees at a common asset level (which is based on the subject fund's current total net assets value). The second column displays actual management fees (based on the fund's fiscal year-end). The third column shows actual nonmanagement expenses, and the fourth column shows actual total expenses.

Expense Quintiles

The subject fund's expenses are ranked within the Expense Group. A fund with the lowest expense is ranked first, and a fund with the highest expense is ranked last. For example, a fund with the third

lowest total expense ratio in a 15-fund group would be ranked "3/15."

The expense quintile summary illustrates the position of the subject fund within the Expense Group. For purposes of expenses, the quintiles are defined as follows:

1st Quintile	=	Lowest/Best 20%
2nd Quintile	=	Next 20%
3rd Quintile	=	Next 20%
4th Quintile	=	Next 20%
5th Quintile	=	Highest/Worst 20%

For example, assume expenses are proportionately distributed between 1.000% and 2.000%. The quintiles would be calculated as follows, where any fund falling in the expense range would be in the associated quintile shown on the left:

		Expense Range	Quintile Break
1st Quintile	=	1.000% - 1.200%	
2nd Quintile	=	1.201% - 1.400%	1.201%
3rd Quintile	=	1.401% - 1.600%	1.401%
4th Quintile	=	1.601% - 1.800%	1.601%
5th Quintile	=	1.801% - 2.000%	1.801%

Executive Summary—Performance

The Performance Universe quintile summary displays annualized performance data and sharpe ratios for one, two, three, four, five, and ten years. Some of the quintile boxes are blank if the subject fund

was not in existence during the entire performance period.

Performance Quintiles

The subject fund's performance is ranked within a Performance Universe. A fund with the highest performance is ranked first, and a fund with the lowest performance is ranked last. For example, a fund with the highest performance in a 50-fund universe would be ranked one of 50 ("1/50").

The performance quintile summary illustrates the quintile position of the subject fund within the Performance Universe. For purposes of total return, the quintiles are defined as follows:

1st Quintile	=	Highest/Best 20%
2nd Quintile	=	Next 20%
3rd Quintile	=	Next 20%
4th Quintile	=	Next 20%
5th Quintile	=	Lowest/Worst 20%

Note: The performance quintile methodology is the opposite of the expense quintile methodology (e.g., the highest expense is defined as being in the 5th quintile, and the highest total return is defined as being in the 1st quintile, etc.).

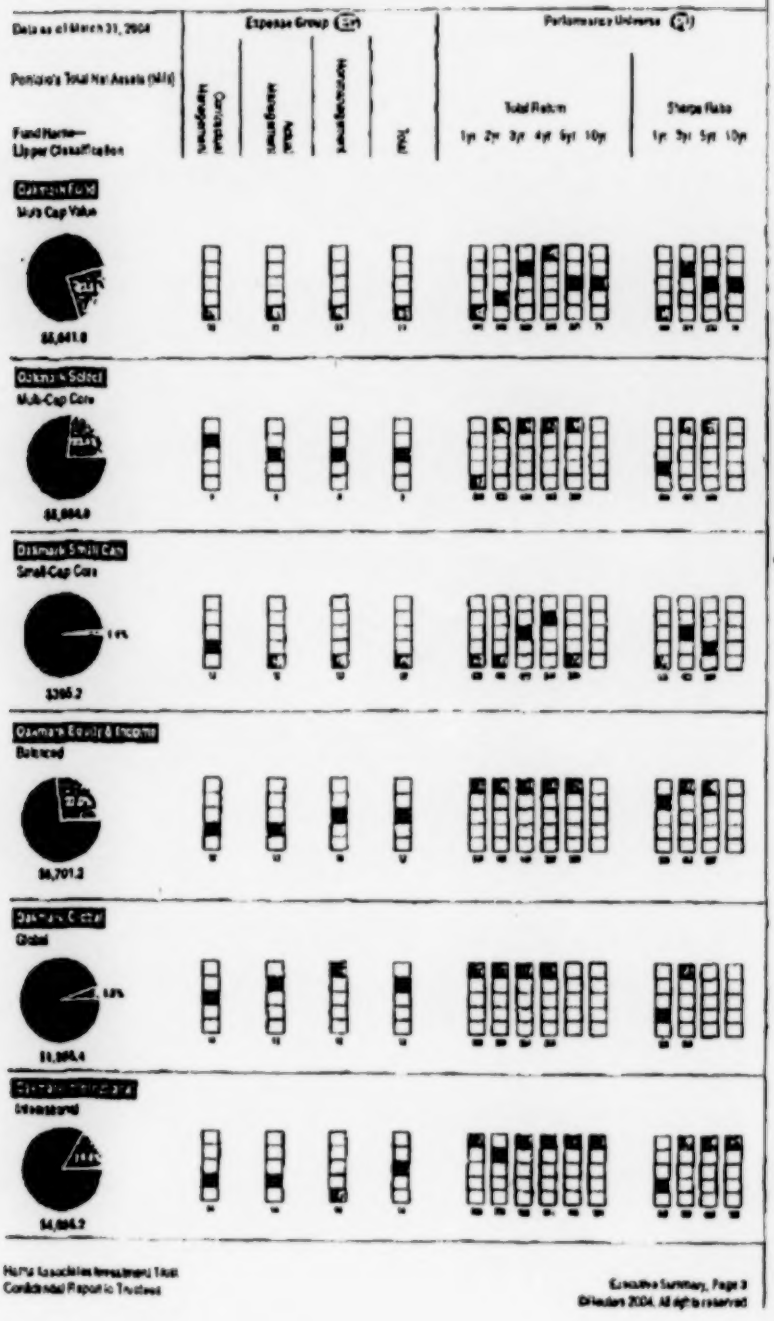
For example, assume total return performance values are proportionately distributed between 10.00% and 20.00%. The quintiles would be calculated as follows:

		Performance Range	Quintile Break
1st Quintile	=	18.00% - 20.00%	18.00%
2nd Quintile	=	16.00% - 17.99%	16.00%
3rd Quintile	=	14.00% - 15.99%	14.00%
4th Quintile	=	12.00% -13.99%	12.00%
5th Quintile	=	10.00% -11.99%	

Lipper Leaders

Additionally, the new Lipper Leader system that scores funds based on five different measures is included on pages 5-6. The Lipper scores are derived from highly sophisticated algorithms that analyze funds against clearly defined criteria. Funds are compared to similar funds, and only those that truly stand out are awarded Lipper Leader status. Each fund is ranked against its peers based on the metric used (Total Return, Consistent Return, Preservation, Tax Efficiency, and Expense), and the highest 20% of funds in each peer group are named Lipper Leaders, the next 20% receive a score of 2, the middle 20% are scored 3, the next 20% are scored 4, and the lowest 20% are scored 5. While Lipper Leader scores are not predictive of future performance or appropriateness, they do provide context and perspective for making knowledgeable fund investment decisions.

Executive Summary—Quintile Rankings



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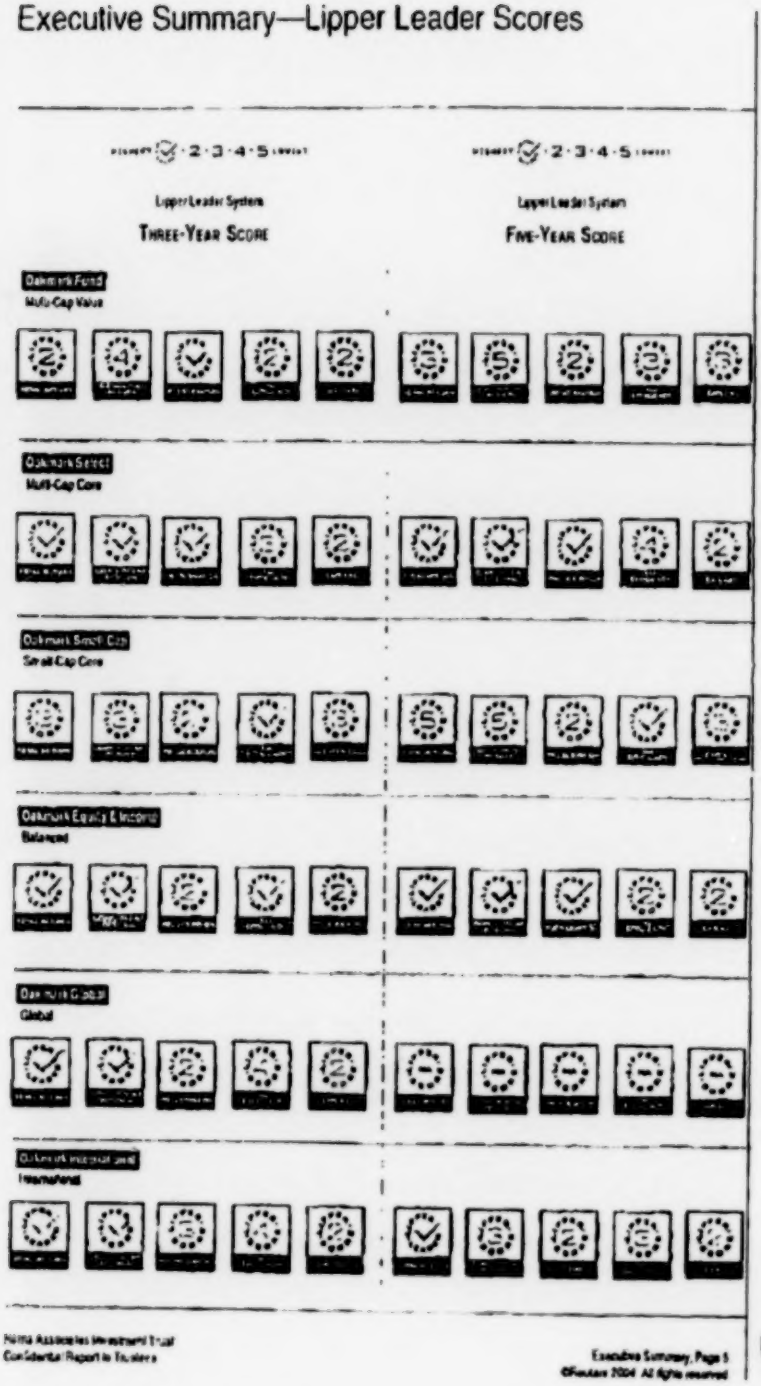
Executive Summary—Lipper Leader Scores



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Fund Summary—Expenses

Peer Groups

Equity & Income

Expense Group

The Expense Group consists of the Harris Associates Investment Trust: Oakmark Equity & Income Fund (the "Portfolio"), Class I Shares (the "Fund") and 11 other balanced* funds, as classified by Lipper. Only retail no-load funds were considered for inclusion in the group.

Average net assets of the 12 funds in the group, including all classes of shares, range from $226.1 million to $9.813 billion. Three of the funds are larger than the Portfolio, and eight are smaller, based on the most recently reported fiscal period of the funds.

Expense Universe

The Expense Universe consists of the Fund, the Expense Group, and all other retail no-load balanced funds, excluding outliers.

Lipper Investment Classification/Objective

The classification/objective consists of the Portfolio and a representative class/fund from each portfolio in the retail balanced classification, excluding outliers.

*Please see the Investment Classification/Objectives following the Glossary in the back of the book for a full definition.

Expense Rankings and Quintiles

	Rank in Expense Group	Expense Group Quintile	Rank in Expense Universe	Expense Universe Quintile
Contractual Management Fees	9 / 12	4th	---	---
Total Expenses Including 12b-1/Non-12b-1 Service Fees	7 / 12	3rd	15 / 53	2nd
Management Fees	9 / 12	4th	31 / 53	3rd
Nonmanagement Expenses	7 / 12	3rd	14 / 53	2nd

As an example, a fund that ranks 1/15 would have the lowest expenses (1st quintile).

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Fund Summary—Performance

Peer Groups

Equity & Income

Performance Group

The Performance Group is identical to the Expense Group.

Performance Universe

The Performance Universe consists of the Fund and all retail and institutional balanced funds regardless of asset size or primary channel of distribution.

Performance Rankings and Quintiles

Total Return for One-Year Periods Ended 03/31	Rank in Performance Group	Performance Group Quintile	Rank in Performance Universe	Performance Universe Quintile
2004	4 / 12	2nd	53 / 530	1st
2003	2 / 12	1st	41 / 485	1st
2002	1 / 11	1st	4 / 445	1st
2001	1 / 11	1st	1 / 393	1st
2000	5 / 11	2nd	143 / 369	2nd
1999	9 / 11	4th	236 / 339	4th
1998	3 / 11	1st	42 / 277	1st
1997	2 / 11	1st	18 / 220	1st

Total Return (Annualized) for Periods Ended 03/31/04	Rank in Performance Group	Performance Group Quintile	Rank in Performance Universe	Performance Universe Quintile
One Year	4 / 12	2nd	53 / 530	1st
Two Years	2 / 12	1st	6 / 486	1st
Three Years	1 / 11	1st	3 / 445	1st
Four Years	1 / 11	1st	2 / 393	1st
Five Years	1 / 11	1st	1 / 369	1st

As an example, a fund that ranks 1/15 would have the highest performance (1st quintile)

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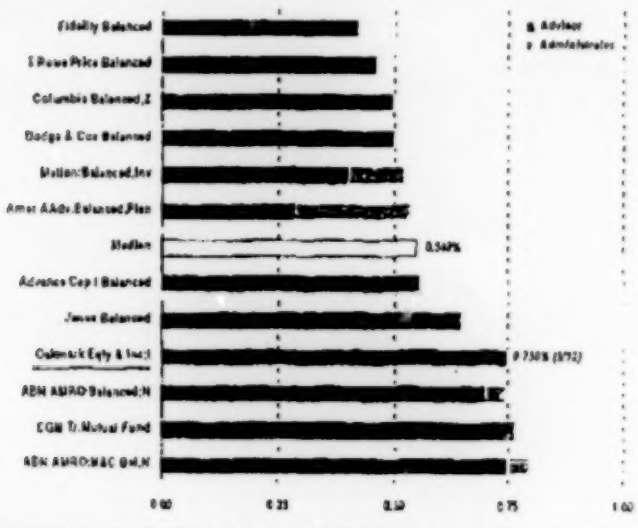
Contractual Management Fees

Equity & Income

Figure 1 Contractual Management Fees at Common Asset Level ($6,725 Mil)



The common asset level used in Figure 1 is the approximate current size of the subject Fund/Portfolio

Figure 2 Contractual Management Fees at Various Asset Levels

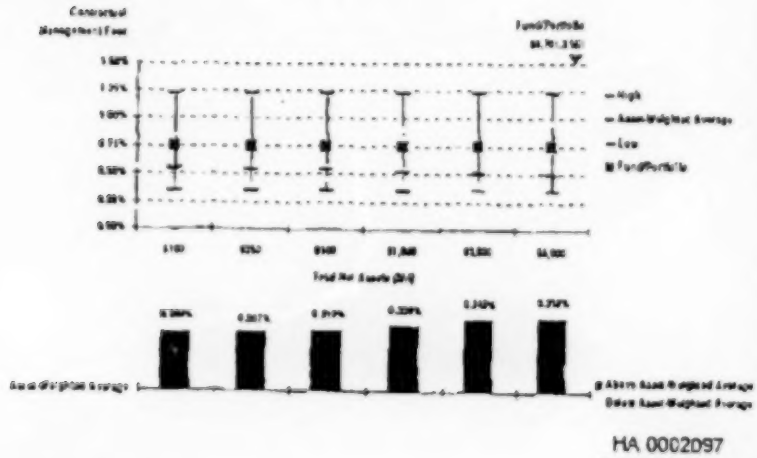


Figure 2 shows contractual management fees for funds with the same investment classification/objective as the Fund/Portfolio. The chart below shows the spread between the Fund/Portfolio and the asset-weighted average of funds in the investment classification/objective. (See "Asset-Weighted Average" in the Glossary for a numeric example of the computation.)

This chart displays possible breakpoint utilization in a management fee schedule by indicating relative effective fees at various (hypothetical) asset levels, i.e., descending fee as assets climb indicates breakpoints. More importantly, it may assist in determining how the Fund's/Portfolio's fee will compare as assets grow or contract over time.

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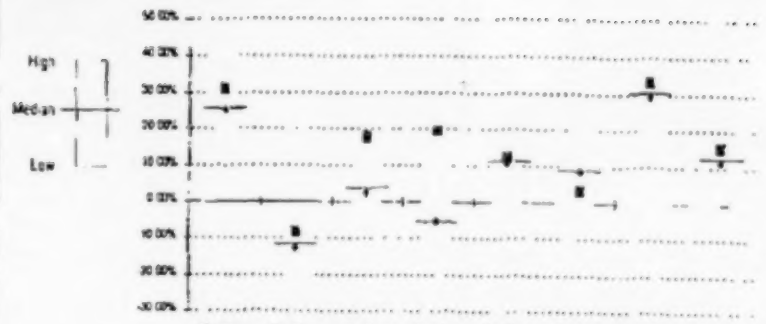
Total Return Performance

One-Year Periods—Group

TOTAL RETURN PERFORMANCE—ONE-YEAR PERIODS (GROUP)

FIGURE 10 TOTAL RETURN PERFORMANCE



	One Year Ended 03/31/04	One Year Ended 03/31/03	One Year Ended 03/31/02	One Year Ended 03/31/01	One Year Ended 03/31/00	One Year Ended 03/31/99	One Year Ended 03/31/98	One Year Ended 03/31/97
High	43.84%	-8.19%	18.07%	19.54%	19.72%	33.17%	34.65%	17.08%
Low	13.65%	-20.52%	-0.38%	-17.91%	-2.42%	-0.67%	15.91%	10.05%
Median	25.72%	-11.37%	3.81%	9.31%	11.17%	8.88%	30.48%	12.58%
Average	26.94%	-11.65%	5.72%	-1.41%	10.52%	11.11%	27.31%	13.01%
Standard Deviation	8.42%	3.42%	6.38%	12.28%	5.98%	8.74%	6.83%	2.19%
20th Percentile	33.88%	-8.72%	8.24%	11.21%	12.71%	17.69%	33.67%	14.88%
40th Percentile	29.28%	-10.55%	5.45%	-0.61%	12.58%	15.51%	31.62%	13.67%
60th Percentile	24.08%	-13.21%	3.87%	-8.47%	10.52%	6.02%	26.72%	12.45%
80th Percentile	20.72%	-13.92%	2.46%	-11.42%	7.28%	3.42%	27.71%	11.01%
Oakmark Eqty & Incl *	31.25%	-8.31%	18.07%	16.54%	12.80%	3.48%	33.57%	15.74%
Rank	4/12	2/12	1/11	1/11	4/11	5/11	3/11	2/11
Lipper Balanced Fd Index *	25.10%	-12.83%	2.48%	-5.58%	10.45%	8.38%	29.21%	11.06%

Data is inclusive of the Performance Group.

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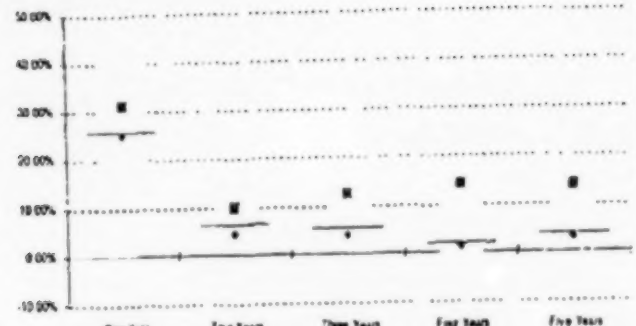
Total Return Performance

Annualized Periods—Group

Equity & Income

FIGURE 11 TOTAL RETURN PERFORMANCE



	One Year Ended 03/31/04	Two Years Ended 03/31/04	Three Years Ended 03/31/04	Four Years Ended 03/31/04	Five Years Ended 03/31/04
High	43.94%	10.22%	12.48%	14.22%	13.91%
Low	13.85%	0.97%	1.21%	2.06%	0.19%
Median	29.73%	8.22%	9.41%	2.67%	3.78%
Average	26.84%	5.60%	5.71%	3.64%	5.10%
Standard Deviation	8.42%	3.10%	3.84%	3.89%	4.22%
20th Percentile	32.68%	8.42%	6.20%	6.20%	6.19%
40th Percentile	28.26%	6.71%	6.20%	4.49%	6.82%
60th Percentile	24.36%	5.58%	4.72%	0.48%	2.98%
80th Percentile	20.72%	3.14%	2.49%	-0.06%	1.64%
Gatemark Eqty & Inc.*	31.38%	9.80%	12.49%	14.22%	13.91%
Rank	4/12	3/12	1/11	1/11	1/11
Lipper Balanced Fd Index*	28.10%	4.41%	3.75%	1.25%	2.11%

Data is inclusive of the Performance Group.

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Harris Associates Investment Trust
Gatemark Equity & Income Fund
Confidential Report to Trustees

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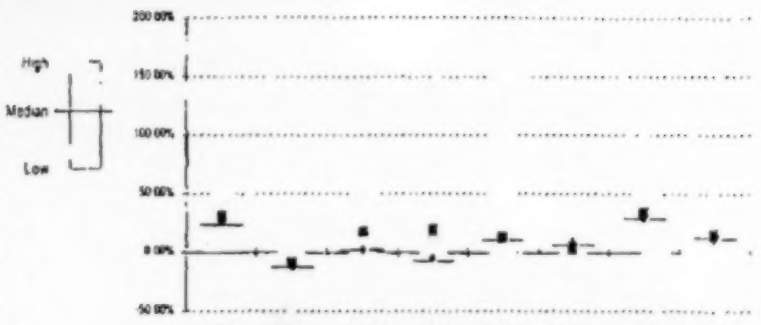
Equity & Income

Total Return Performance

One-Year Periods—Universe

Figure 12 Total Return Performance



	One Year Ended 03/31/04	One Year Ended 03/31/03	One Year Ended 03/31/02	One Year Ended 03/31/01	One Year Ended 03/31/00	One Year Ended 03/31/99	One Year Ended 03/31/98	One Year Ended 03/31/97
High	63.11%	0.00%	41.82%	16.54%	151.48%	31.62%	47.35%	20.61%
Low	2.82%	-30.72%	-8.89%	-34.66%	-6.54%	-21.07%	0.38%	1.10%
Median	23.42%	-18.19%	1.83%	-7.71%	10.84%	6.05%	25.01%	11.36%
Average	23.80%	-13.25%	1.73%	-4.06%	10.99%	7.56%	24.47%	10.87%
Standard Deviation	8.82%	7.95%	5.92%	8.39%	11.34%	7.62%	6.73%	3.47%
80th Percentile	37.34%	-10.37%	3.84%	3.47%	16.76%	12.11%	32.84%	13.21%
60th Percentile	24.56%	-12.49%	2.47%	-6.41%	12.27%	8.75%	30.39%	12.09%
40th Percentile	22.08%	-13.81%	0.87%	-13.08%	8.25%	4.36%	21.65%	10.41%
20th Percentile	19.82%	-16.05%	-1.18%	-12.48%	3.41%	2.31%	24.40%	7.82%
Oakmark Equity & Incom	31.38%	-8.36%	14.82%	19.64%	12.85%	3.48%	23.87%	16.71%
Rank	39/538	41/448	6/415	5/350	141/361	236/329	43/277	16/238
Lipper Balanced Fd Index	26.10%	-12.63%	2.48%	-3.36%	12.45%	8.36%	26.21%	11.09%

Data is inclusive of the Performance Universe.

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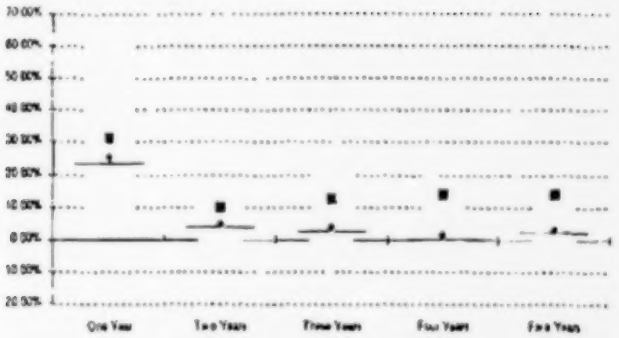
Total Return Performance

Annualized Periods—Universe

Equity & Income

FIGURE 13 TOTAL RETURN PERFORMANCE



	One Year Ended 03/31/04	Two Years Ended 03/31/04	Three Years Ended 03/31/04	Four Years Ended 03/31/04	Five Years Ended 03/31/04
High	63.11%	13.22%	18.77%	15.82%	13.91%
Low	2.83%	-7.33%	-4.87%	-8.81%	-4.47%
Median	23.42%	3.56%	3.62%	0.32%	3.31%
Average	23.66%	3.55%	3.92%	0.49%	2.47%
Standard Deviation	5.22%	2.38%	3.61%	3.74%	3.77%
20th Percentile	27.64%	5.50%	4.73%	3.37%	4.54%
40th Percentile	24.56%	4.14%	3.37%	0.87%	2.99%
60th Percentile	22.06%	3.00%	2.11%	-0.38%	1.85%
80th Percentile	19.92%	1.88%	1.81%	-2.25%	0.31%
Oakmark Eqty & Incl ▲	31.36%	8.83%	12.41%	14.23%	13.01%
Rank	13/531	6/466	3/445	2/369	1/369
Lipper Balanced Fd Index ▲	25.10%	4.41%	3.76%	1.35%	3.11%

Data is inclusive of the Performance Universe

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Equity & Income

Figure 16 Performance Consistency

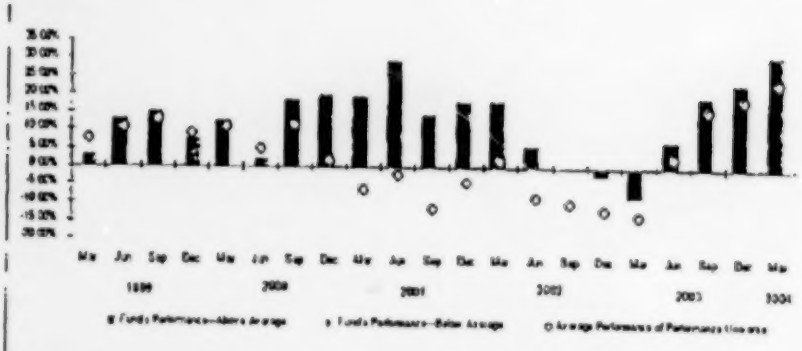

Figure 16 depicts rolling 12-month performance each quarter for the last five years

Figure 17 Performance Range

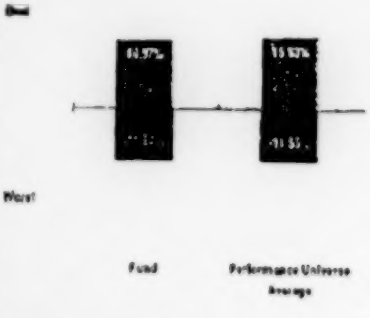

Figure 17 shows total return performance for the three best and three worst consecutive months since the inception of the Fund compared to the Performance Universe average

Figure 18 Performance Quintile Distribution

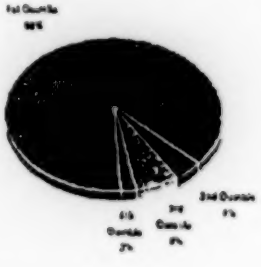

Figure 18 is based on rolling 12-month performance each month over five years (or any time period up to ten years) and shows the percentage of these observations the Fund ranked within each of five quintiles

Figure 19 Absolute Performance

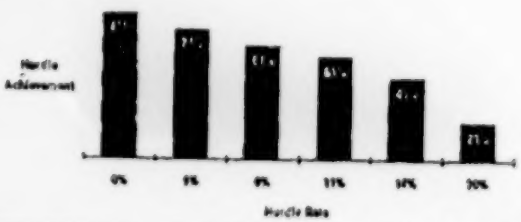

Figure 19 shows the frequency with which the Fund's total return performance (calculated for each rolling 12-month period monthly over the last five years or since inception) exceeded predetermined performance levels, identified as Hurdle Rates

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Fund Summary—Expenses

Peer Groups

Global

Expense Group

The Expense Group consists of the Harris Associates Investment Trust, Oakmark Global Fund (the "Portfolio"), Class I Shares (the "Fund") and 11 other global funds, as classified by Lipper. Only retail no-load funds were considered for inclusion in the group.

Average net assets of the 12 funds in the group, including all classes of shares, range from $21.2 million to $4.278 billion. Two of the funds are larger than the Portfolio, and nine are smaller, based on the most recently reported fiscal period of the funds.

Note: The Tweedy Browne fund was added to the Expense Group at the request of Harris Associates. The Tweedy Browne fund was not originally included in the Expense Group because of its portfolio asset size compared to the Portfolio.

Expense Universe

The Expense Universe consists of the Fund, the Expense Group, and all other retail no-load global funds, excluding outliers.

Lipper Investment Classification/Objective

The classification/objective consists of the Portfolio and a representative class/fund from each portfolio in the retail global classification, excluding outliers.

*Please see the Investment Classifications/Objectives following the Glossary in the back of the book for a full definition.

Expense Rankings and Quintiles

	Rank In Expense Group	Expense Group Quintile	Rank In Expense Universe	Expense Universe Quintile
Contractual Management Fees	6 / 12	3rd	...	...
Total Expenses Including 12b-1/Non-12b-1 Service Fees	4 / 12	2nd	5 / 18	2nd
Management Fees	5 / 12	2nd	8 / 18	3rd
Nonmanagement Expenses	3 / 12	1st	4 / 18	1st

As an example, a fund that ranks 1/15 would have the lowest expenses (1st quintile).

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Global

Fund Summary—Performance

Peer Groups

Performance Group [1]

The Performance Group is identical to the Expense Group

Performance Universe [1]

The Performance Universe consists of the Fund and all retail and institutional global funds regardless of asset size or primary channel of distribution

Performance Rankings and Quintiles

Total Return for One-Year Periods Ended 03/31	Rank in Performance Group [2]	Performance Group Quintile	Rank in Performance Universe [1]	Performance Universe Quintile
2004	1 / 12	1st	1 / 322	1st
2003	2 / 13	1st	62 / 290	2nd
2002	1 / 11	1st	1 / 254	1st
2001	1 / 11	1st	5 / 205	1st

Total Return (Annualized) for Periods Ended 03/31/04	Rank in Performance Group [2]	Performance Group Quintile	Rank in Performance Universe [1]	Performance Universe Quintile
One Year	1 / 12	1st	1 / 322	1st
Two Years	2 / 12	1st	5 / 290	1st
Three Years	1 / 11	1st	1 / 254	1st
Four Years	1 / 11	1st	1 / 205	1st

As an example, a fund that ranks 1/15 would have the highest performance (1st quintile)

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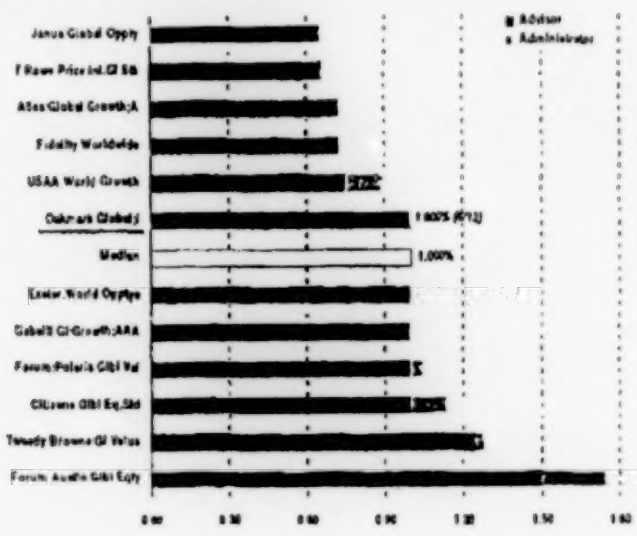
Figure 1 Contractual Management Fees at Common Asset Level ($1,375 Mil.)



The common asset level used in Figure 1 is the approximate current size of the subject Fund/Portfolio

Figure 2 Contractual Management Fees at Various Asset Levels

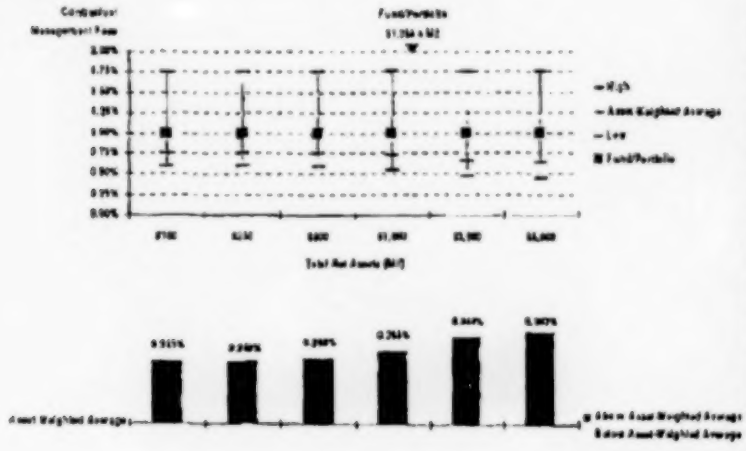


Figure 2 shows contractual management fees for funds with the same investment classification/objective as the Fund/Portfolio. The chart below shows the spread between the Fund/Portfolio and the asset-weighted average of funds in the investment classification/objective. (See "Asset-Weighted Average" in the Glossary for a numeric example of the computation.)

This chart displays possible breakpoint utilization in a management fee schedule by indicating relative effective fees at various (hypothetical) asset levels, i.e., descending fee as assets climb indicates breakpoints. More importantly, it may assist in determining how the Fund's/Portfolio's fee will compare as assets grow or contract over time.

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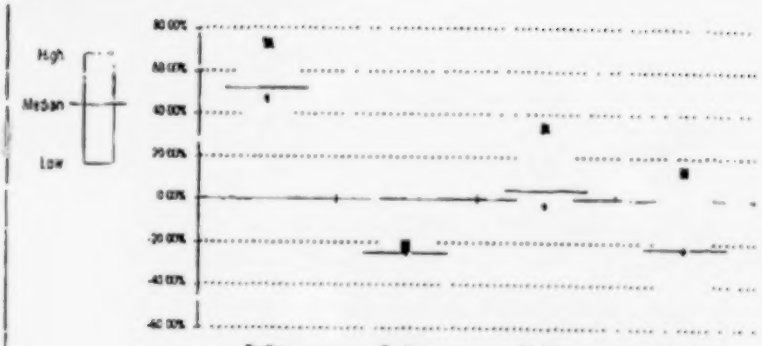
Global

Total Return Performance

One-Year Periods—Group

Total Return Performance—One-Year Periods (Group)

Figure 10 Total Return Performance



	One Year Ended 03/31/04	One Year Ended 03/31/03	One Year Ended 03/31/02	One Year Ended 03/31/01
High	73.04%	-17.52%	34.04%	14.11%
Low	21.93%	-31.73%	-16.02%	-46.38%
Median	51.78%	-25.06%	4.21%	-32.30%
Average	52.84%	-25.06%	3.94%	-18.17%
Standard Deviation	12.52%	3.77%	13.78%	20.10%
20th Percentile	64.24%	-23.84%	9.58%	0.18%
40th Percentile	64.40%	-24.84%	5.48%	-18.43%
60th Percentile	48.52%	-25.49%	-0.87%	-23.81%
80th Percentile	41.87%	-27.10%	-3.55%	-40.15%
Oakmark Global ▪	73.04%	-21.02%	34.04%	14.11%
Rank	1/12	3/12	1/11	1/11
Lipper Global Fund Index ▪	48.75%	-24.77%	-2.97%	-23.30%

Data is inclusive of the Performance Group

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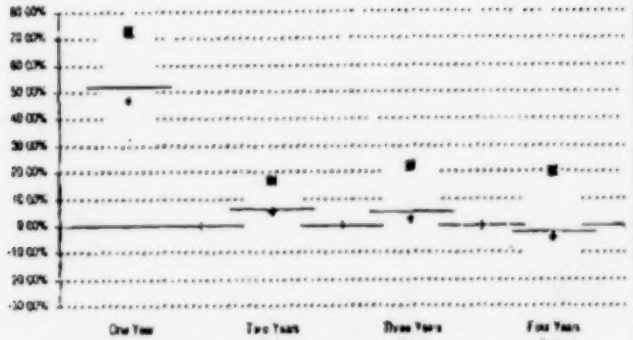
Total Return Performance

Annualized Periods—Group

Global

FIGURE 11 TOTAL RETURN PERFORMANCE



	One Year Ended 03/31/04	Two Years Ended 03/31/04	Three Years Ended 03/31/04	Four Years Ended 03/31/04
High	73.04%	18.20%	22.36%	20.24%
Low	29.62%	-1.48%	-4.28%	-16.60%
Median	61.29%	8.86%	9.17%	-2.20%
Average	52.84%	8.86%	6.90%	-1.32%
Standard Deviation	12.62%	5.60%	8.30%	11.61%
20th Percentile	64.24%	7.40%	8.04%	5.17%
40th Percentile	54.40%	6.41%	6.60%	-0.52%
60th Percentile	49.63%	5.66%	3.19%	-5.67%
80th Percentile	42.63%	3.05%	1.33%	-8.95%
Oakmark Global ●	73.04%	16.80%	22.36%	20.24%
Rank	1/12	2/12	1/11	1/11
Lipper Global Fund Index ●	46.76%	5.57%	3.37%	-4.80%

Data is Inclusive of the Performance Group.

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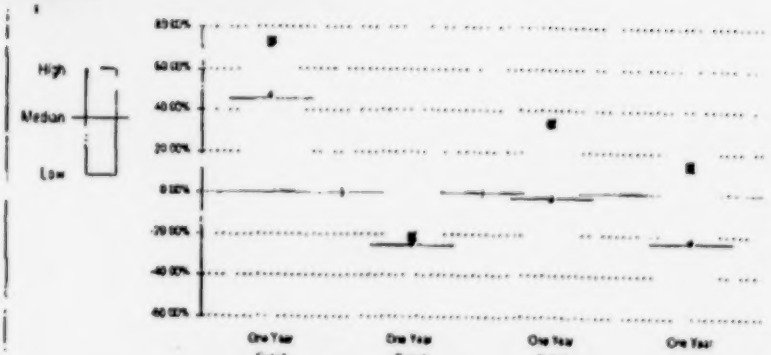
Global

Total Return Performance

One-Year Periods—Universe

Total Return Performance—One-Year Periods (Universe)

Figure 12 Total Return Performance



	One Year Ended 03/31/04	One Year Ended 03/31/03	One Year Ended 03/31/02	One Year Ended 03/31/01
High	73.04%	6.34%	34.08%	26.37%
Low	4.59%	-38.77%	-22.07%	-47.16%
Median	48.77%	-25.72%	-2.47%	-23.91%
Average	45.84%	-24.42%	-2.56%	-22.78%
Standard Deviation	9.70%	8.29%	7.85%	14.33%
10th Percentile	53.72%	-30.55%	2.09%	-11.38%
40th Percentile	47.65%	23.84%	-6.58%	-31.33%
50th Percentile	42.51%	26.62%	-4.84%	-37.48%
60th Percentile	38.10%	31.01%	-8.51%	-31.78%
Oakmark Global	73.04%	-21.82%	34.08%	14.11%
Rank	1/222	62/260	1/254	1/208
Lipper Global Fund Index	48.75%	24.77%	-2.98%	-23.30%

Data is inclusive of the Performance Universe

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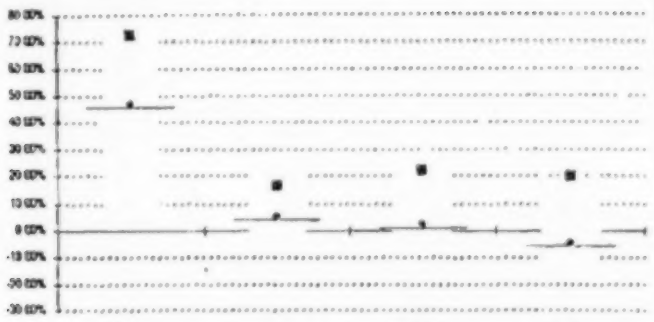
Total Return Performance

Annualized Periods—Universe

Global

Figure 13 Total Return Performance



	One Year Ended 03/31/04	Two Years Ended 03/31/04	Three Years Ended 03/31/04	Four Years Ended 03/31/04
High	73.04%	31.78%	22.96%	20.24%
Low	4.59%	-3.30%	-4.54%	-18.86%
Median	48.71%	4.07%	0.91%	-6.51%
Average	45.64%	4.67%	1.89%	-6.14%
Standard Deviation	9.70%	4.43%	5.07%	7.38%
20th Percentile	53.72%	7.76%	1.21%	-3.62%
40th Percentile	47.85%	5.41%	2.51%	-3.74%
60th Percentile	42.61%	2.78%	-0.37%	-7.36%
80th Percentile	38.10%	1.16%	-2.16%	-11.41%
Oakmark Global3 ■	73.04%	16.90%	22.38%	20.24%
Rank	1/322	5/280	1/284	1/286
Lipper Global Fund index ●	48.75%	5.07%	2.31%	-4.80%

Data is inclusive of the Performance Universe

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Global

FIGURE 16 PERFORMANCE CONSISTENCY

Figure 16 depicts rolling 12-month performance each quarter for the last five years

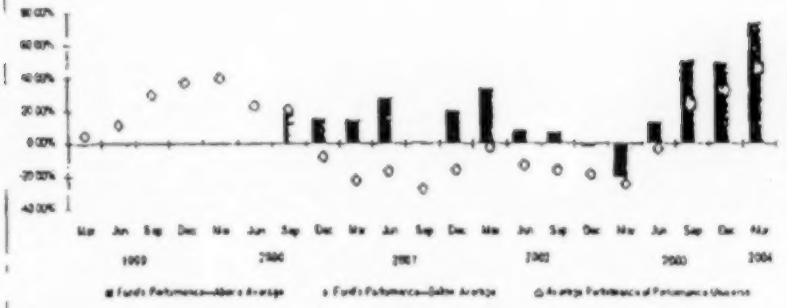


FIGURE 17 PERFORMANCE RANGE

Figure 17 shows total return performance for the three best and three worst consecutive months since the inception of the Fund compared to the Performance Universe average

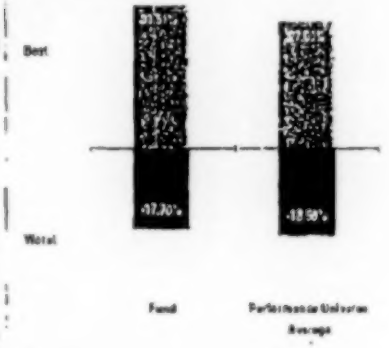


FIGURE 18 PERFORMANCE QUINTILE DISTRIBUTION

Figure 18 is based on rolling 12-month performance each month over five years (or any time period up to ten years) and shows the percentage of those observations the Fund ranked within each of five quintiles

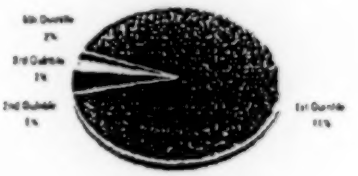
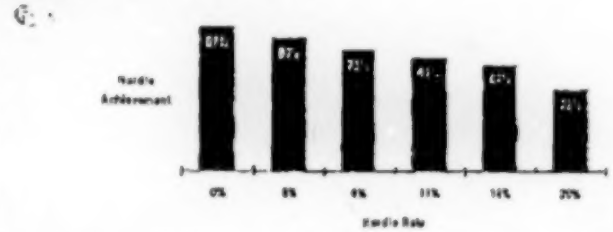


FIGURE 19 ABSOLUTE PERFORMANCE

Figure 19 shows the frequency with which the Fund's total return performance (calculated for each rolling 12 month period monthly over the last five years or since inception) exceeded predetermined performance levels, identified as Hurdle Ratio



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Performance Group

In addition to fund expenses, pertinent comparisons displayed in the Lipper 15(c) report also include total return performance ("performance"). While there are numerous methods to compute performance, the figures presented in this report (unless otherwise noted) are computed using the same methodology as the figures that are compiled by Lipper and published daily in numerous financial newspapers and other publications across the country. Stated simply, all operating expenses are deducted, all distributions are assumed to have been reinvested, and any sales charges are not taken into account. An example of the performance calculation is shown below under "Total Return Performance Calculation."

Selection Criteria

The constituent funds of a performance group may or may not be identical to those in an expense group. The most common instance of differing groups is when an expense group includes a mix of investment classifications/objectives. If more than one investment classification/objective is represented in an expense group, the performance group will include only those funds with the same classification/objective as a subject fund.

Occasionally, certain portfolio characteristics may be considered in order to select a second or alternative performance group. For equity funds, we may identify funds that are highly similar in management style based on market capitalization, price-to-earnings ratio, and price-to-book ratio of the portfolio. Cash positions and dividend yield may be used as additional screening criteria for equity funds. For fixed income funds, we may identify funds based on (bond)

quality ratings and overall duration of the portfolio. Cash positions and foreign debt exposure may also be used as additional screening criteria for fixed income funds.

Total Return Performance Calculation

A Lipper 15(c) report depicts performance using the following general guidelines:

- Performance numbers represent *annualized* total returns (i.e., not cumulative), unless otherwise noted.
- Performance numbers are calculated using a fund's daily net asset value (NAV), which is net of ail fund operating expenses and 12b-1/non-12b-1 service fees; sales charges/loads are *not* taken into account.
- Performance numbers assume reinvestment of income distributions and capital gains on the ex-dividend date, regardless of when the fund actually paid the distribution.
- Lipper collects net asset values (NAVs) electronically from the NASD and fund companies or their administrative service providers. Many fund companies publish NAVs only on the last trading day of the week or month, thus leaving "NAV gaps" in Lipper's database. Where feasible, all performance figures for Lipper's products are calculated as of a month-end date (e.g., December 31, June 30, etc.).

A client may request that performance dates be set to an inception date, the date of a portfolio manager change, or the date of a classification/objective change. Frequently, these events occur mid-month rather than at the end of or on the last trading day of a month. When mid-month performance dates are requested by a client several funds display "N/A" for

performance over that period because of missing NAVs. The result is these funds are excluded from statistics and rankings, providing a poor performance comparison for a subject fund. Therefore, Lipper recommends that performance "start dates" be set to the month-end of the requested date. For example, if a fund's inception date is December 15, 2002, Lipper suggests using December 31, 2002, as the performance start date so all funds in the performance universe or group can be included in the statistics and rankings. Thus, comprehensive benchmarks can be shown in our reports to provide full analytical value.

EXHIBIT 13

Harris Associates Investment Trust

May 25, 2004

Leading Fund Intelligence

Lipper Inc.

Advisory Contract Renewal Reporting
Pursuant to Section 15(c) of the
Investment Company Act of 1940

http://www.lipperweb.com
http://www.lipperleaders.com

Fund Summary—Expenses

Peer Groups

Oakmark
Revised

Expense Group (EG)

The Expense Group consists of the Harris Associates Investment Trust: Oakmark Fund (the "Portfolio"); Class I Shares (the "Fund"), currently classified by Lipper as a multi-cap value* fund, two large-cap value* funds, and eight large-cap core* funds, as classified by Lipper. Only retail no-load funds were considered for inclusion in the group.

Average net assets of the 11 funds in the group, including all classes of shares, range from $755.9 million to $8.954 billion. Two of the funds are larger than the Portfolio, and eight are smaller, based on the most recently reported fiscal period of the funds.

Note: The Fund is currently classified by Lipper as a multi-cap value fund. At the request of the board of trustees, the Fund was compared with large-cap value* funds for expense and performance comparisons. In order to generate a meaningful report, Lipper combined the large-cap value fund objective with the large-cap core fund objective.

Expense Universe (EU)

The Expense Universe consists of the Fund, the Expense Group, and all other retail no-load large-cap value and large-cap core funds, excluding outliers.

Lipper Investment Classification/Objective (CL)

The classification/objective consists of the Portfolio and a representative class/fund from each portfolio in the retail large-cap value classification, excluding outliers.

*Please see the Investment Classifications/Objectives following the Glossary in the back of this book for a full definition.

Expense Rankings and Quintiles

	Rank in Expense Group (EG)	Expense Group Quintile	Rank in Expense Universe (EU)	Expense Universe Quintile
Contractual Management Fees	10 / 11	5th	---	---
Total Expenses Including 12b-1/Non-12b-1 Service Fees	10 / 11	5th	70 / 111	4th
Management Fees	10 / 11	5th	93 / 110	5th
Non-management Expenses	1 / 11	1st	48 / 111	3rd

As an example, a fund that ranks 1/15 would have the lowest expenses (1st quintile).

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Oakmark
Revised

Fund Summary—Performance

Peer Groups

Performance Group (PG)
The Performance Group consists of the Fund and the large-cap value funds in the Expense Group

Note: Only three of the funds in the expense group are large-cap value funds

Performance Universe (PU)
The Performance Universe consists of the Fund and all retail and institutional large-cap value funds regardless of asset size or primary channel of distribution

Performance Rankings and Quintiles

Total Return for One-Year Periods Ended 6/30...	Rank in Performance Group (PG)	Performance Group Quintile	Rank in Performance Universe (PU)	Performance Universe Quintile
2004	3 / 3	N/A	385 / 412	5th
2003	1 / 3	N/A	36 / 367	1st
2002	1 / 3	N/A	7 / 300	1st
2001	1 / 3	N/A	5 / 281	1st
2000	3 / 3	N/A	224 / 224	5th
1999	3 / 3	N/A	169 / 196	5th
1998	3 / 3	N/A	83 / 168	3rd
1997	3 / 3	N/A	67 / 137	3rd
1996	3 / 3	N/A	75 / 115	4th
1995	1 / 3	N/A	2 / 85	1st

As an example, a fund that ranks 1/15 would have the highest performance (1st quintile)

Total Return (Annualized) for Periods Ended 6/30/04	Rank in Performance Group (PG)	Performance Group Quintile	Rank in Performance Universe (PU)	Performance Universe Quintile
One Year	3 / 3	N/A	385 / 412	5th
Two Years	1 / 3	N/A	126 / 367	2nd
Three Years	1 / 3	N/A	121 / 307	2nd
Four Years	1 / 3	N/A	7 / 261	1st
Five Years	1 / 3	N/A	10 / 224	1st
Ten Years	2 / 3	N/A	23 / 85	2nd

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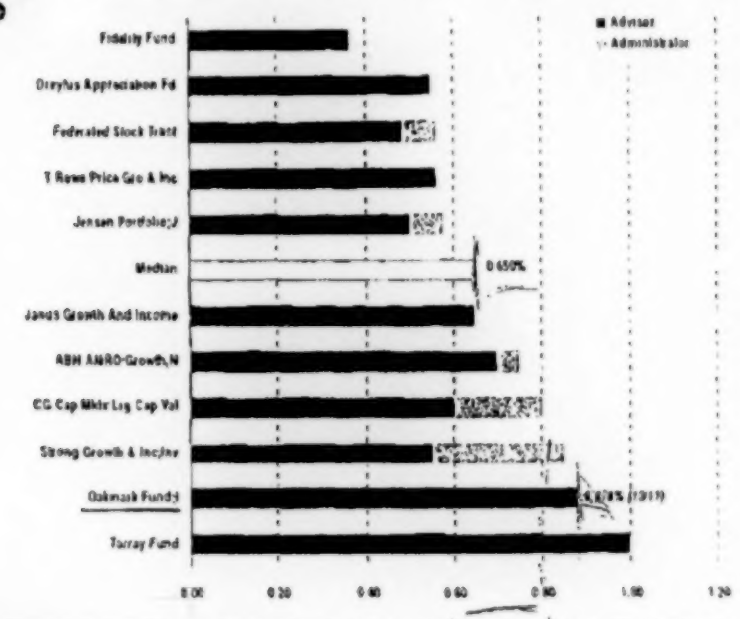
Contractual Management Fees

Oakmark Revised

FIGURE 1 CONTRACTUAL MANAGEMENT FEES AT COMMON ASSET LEVEL ($5,850 MIL)



The common asset level used in Figure 1 is the approximate current size of the subject Fund/Portfolio

FIGURE 2 CONTRACTUAL MANAGEMENT FEES AT VARIOUS ASSET LEVELS

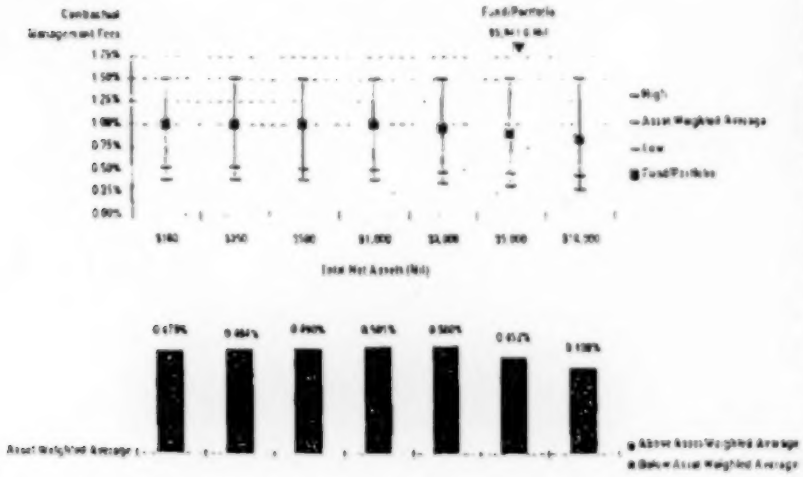


Figure 2 shows contractual management fees for funds with the same investment classification/objective as the Fund/Portfolio. The chart below shows the spread between the Fund/Portfolio and the asset-weighted average of funds in the investment classification/objective. (See "Asset-Weighted Average" in the Glossary for a numeric example of the computation.)

This chart displays possible breakpoint utilization in a management fee schedule by indicating relative effective fees at various (hypothetical) asset levels, i.e., descending fee as assets climb indicates breakpoints. More importantly, it may assist in determining how the Fund's/Portfolio's fee will compare as assets grow or contract over time.

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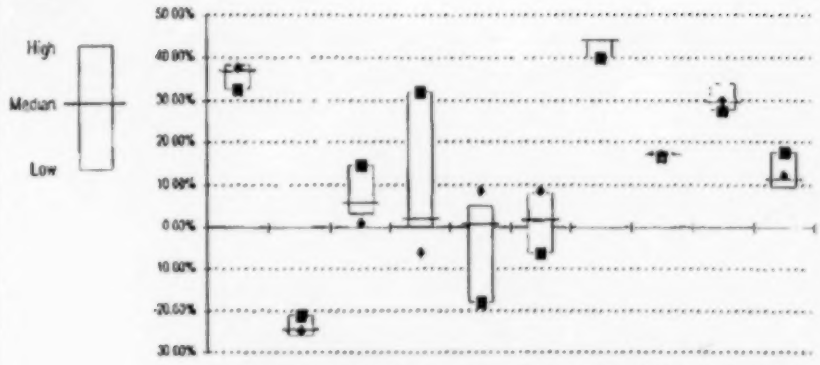
Oakmark
Revised

Total Return Performance

One-Year Periods—Group

FIGURE 10 TOTAL RETURN PERFORMANCE

BG



	One Year Ended 03/31/04	One Year Ended 03/31/03	One Year Ended 03/31/02	One Year Ended 03/31/01	One Year Ended 03/31/00	One Year Ended 03/31/99	One Year Ended 03/31/98	One Year Ended 03/31/97	One Year Ended 03/31/96	One Year Ended 03/31/95
High	38.31%	-21.19%	14.76%	31.89%	5.05%	8.24%	44.34%	17.52%	34.04%	17.72%
Low	32.52%	-25.02%	2.84%	-0.19%	-18.11%	-6.10%	40.19%	16.68%	27.49%	9.53%
Median	37.05%	24.51%	5.89%	2.17%	0.56%	1.58%	44.17%	16.85%	29.59%	11.14%
Average	36.06%	-22.91%	7.78%	11.28%	-4.17%	1.24%	42.90%	17.02%	30.37%	12.86%
Standard Deviation	3.04%	2.47%	6.31%	17.86%	13.28%	7.10%	2.35%	0.44%	3.34%	4.34%
30th Percentile	---	---	---	---	---	---	---	---	---	---
40th Percentile	---	---	---	---	---	---	---	---	---	---
60th Percentile	---	---	---	---	---	---	---	---	---	---
80th Percentile	---	---	---	---	---	---	---	---	---	---
Oakmark Fund †	32.52%	-21.19%	14.76%	31.89%	-18.11%	-6.10%	40.19%	16.68%	27.49%	17.72%
Rank	3/3	1/3	1/3	1/3	3/3	3/3	3/3	3/3	3/3	1/3
Lipper Lg Cap Value Index	37.82%	-25.01%	1.02%	6.05%	8.39%	8.54%	60.63%	17.02%	29.91%	12.08%

Data is inclusive of the Performance Group

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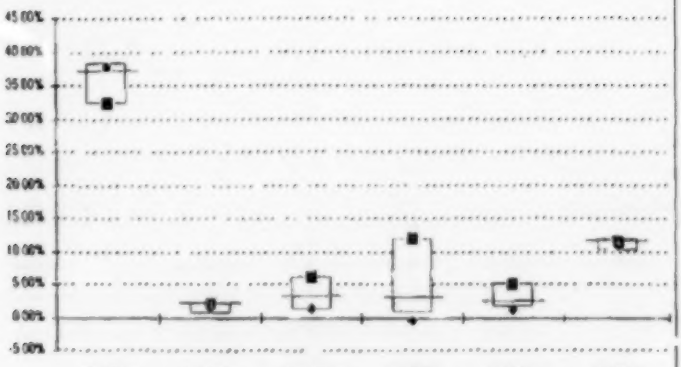
Total Return Performance

Annualized Periods—Group

Oakmark
Revised

FIGURE 11 TOTAL RETURN PERFORMANCE

PG



	One Year Ended 03/31/04	Two Years Ended 03/31/04	Three Years Ended 03/31/04	Four Years Ended 03/31/04	Five Years Ended 03/31/04	Ten Years Ended 03/31/04
High	38.31%	2.38%	6.22%	12.12%	9.29%	11.97%
Low	32.53%	0.78%	1.42%	1.81%	1.81%	10.28%
Median	37.05%	2.15%	3.34%	3.04%	2.54%	11.55%
Average	35.96%	1.69%	3.66%	5.39%	3.71%	11.37%
Standard Deviation	3.04%	0.86%	2.42%	5.82%	1.84%	0.68%
20th Percentile	---	---	---	---	---	---
40th Percentile	--	--	---	---	---	---
60th Percentile	---	--	---	---	--	--
80th Percentile	---	---	---	---	---	---
Oakmark Fund	32.53%	2.38%	6.22%	12.12%	9.29%	11.55%
Rank	3/3	1/3	1/3	1/3	1/3	3/3
Lipper Lg-Cap Value Index	37.62%	1.64%	1.43%	-0.50%	1.22%	10.78%

Data is inclusive of the Performance Group

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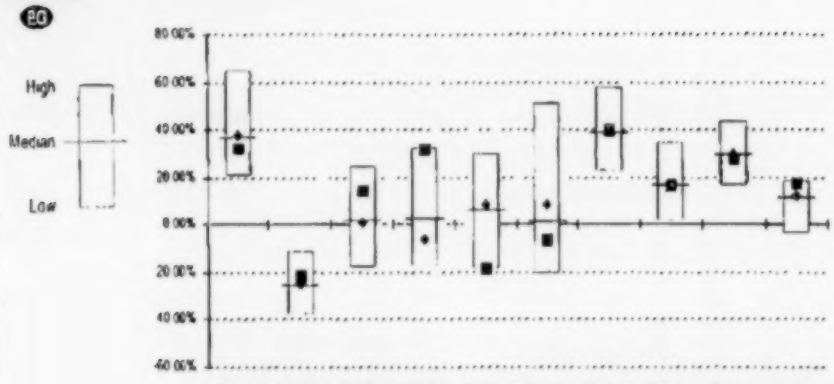
LIPPER

Oakmark Revised

Total Return Performance

One-Year Periods--Universe

Figure 12 Total Return Performance



	One Year Ended 03/31/04	One Year Ended 03/31/03	One Year Ended 03/31/02	One Year Ended 03/31/01	One Year Ended 03/31/00	One Year Ended 03/31/99	One Year Ended 03/31/98	One Year Ended 03/31/97	One Year Ended 03/31/96	One Year Ended 03/31/95
High	65.31%	-11.38%	24.74%	32.43%	29.96%	51.33%	57.78%	34.97%	43.53%	18.57%
Low	21.29%	-37.38%	-17.86%	-17.26%	-18.11%	-20.37%	22.87%	1.68%	17.00%	-3.28%
Median	37.33%	-25.58%	1.70%	2.41%	8.12%	1.62%	38.98%	16.62%	29.31%	11.37%
Average	38.08%	-25.42%	1.84%	2.63%	4.95%	1.87%	39.02%	16.73%	29.62%	10.79%
Standard Deviation	5.47%	3.54%	5.35%	9.75%	7.86%	8.38%	5.15%	3.86%	8.78%	4.52%
20th Percentile	41.50%	-23.06%	5.30%	9.84%	12.26%	6.38%	42.74%	18.99%	33.42%	14.21%
40th Percentile	38.11%	-24.71%	2.47%	3.52%	7.86%	3.32%	40.33%	17.16%	31.12%	12.58%
60th Percentile	36.44%	-26.16%	0.82%	0.64%	2.16%	0.62%	37.89%	16.08%	28.34%	10.75%
80th Percentile	34.49%	-27.94%	-2.31%	5.29%	-2.33%	-2.35%	34.96%	14.18%	25.68%	7.20%
Oakmark Fund ■	32.53%	-21.19%	11.76%	31.85%	-18.11%	6.10%	40.19%	16.68%	27.49%	17.72%
Rank	385/412	36/367	7/307	5/261	224/224	169/196	63/168	67/137	75/115	2/85
Lipper Lg-Cap Value Index ◇	37.02%	-25.04%	1.02%	-6.07%	8.39%	8.56%	40.63%	17.02%	29.91%	12.08%

Data is inclusive of the Performance Universe

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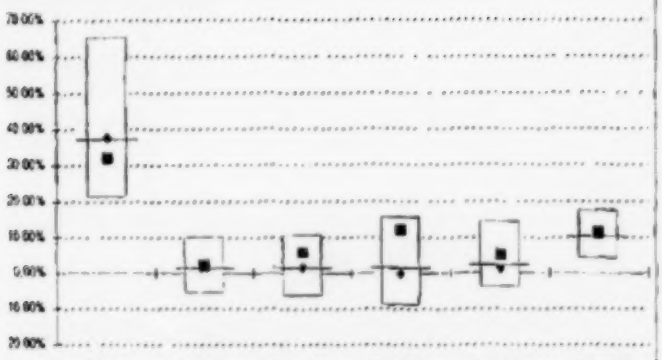
Total Return Performance

Annualized Periods—Universe

Oakmark Revised

FIGURE 13 TOTAL RETURN PERFORMANCE

PU



	One Year Ended 03/31/04	Two Years Ended 03/31/04	Three Years Ended 03/31/04	Four Years Ended 03/31/04	Five Years Ended 03/31/04	Ten Years Ended 03/31/04
High	65.31%	15.36%	10.61%	15.70%	14.38%	17.50%
Low	21.29%	-5.56%	-6.60%	-8.74%	-3.73%	4.25%
Median	37.33%	1.53%	1.29%	1.26%	2.08%	10.21%
Average	38.08%	1.45%	1.53%	1.63%	2.27%	10.23%
Standard Deviation	6.47%	2.22%	2.64%	3.07%	2.90%	2.12%
20th Percentile	41.50%	3.00%	3.47%	4.37%	4.11%	11.69%
40th Percentile	38.11%	1.95%	2.07%	2.86%	2.83%	10.72%
60th Percentile	36.44%	0.86%	0.79%	0.41%	1.51%	9.82%
80th Percentile	34.48%	-0.37%	-0.39%	-1.35%	-0.12%	8.51%
Oakmark Fund,J ●	32.53%	2.23%	6.22%	12.12%	5.29%	11.95%
Rank	305/412	126/367	12/307	7/251	16/224	23/85
Lipper Lg Cap Value Index ●	37.62%	1.64%	1.43%	-0.50%	1.22%	10.70%

Data is inclusive of the Performance Universe

Harris Associates Investment Trust
Oakmark Fund
Confidential Report to Trustees

Section 1, Page 13 of 16

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LIPPER

HA 0089107

Oakmark
Revised

Performance Analysis

FIGURE 16 PERFORMANCE CONSISTENCY

(FU)

Figure 16 depicts rolling 12-month performance each quarter for the last five years

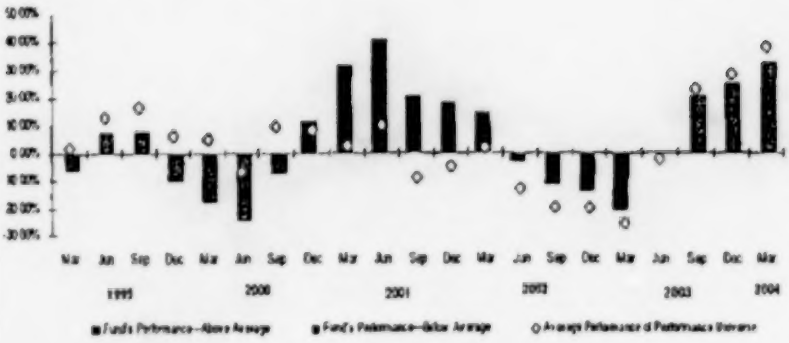

FIGURE 17 PERFORMANCE RANGE

(FU)

Figure 17 shows total return performance for the three best and three worst consecutive months since the inception of the Fund compared to the Performance Universe average

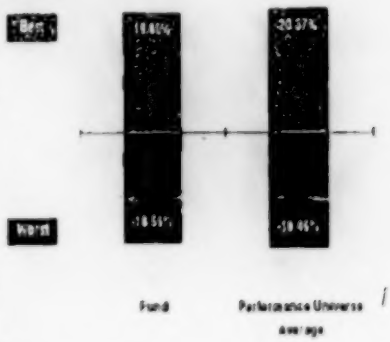

FIGURE 18 PERFORMANCE QUINTILE DISTRIBUTION

(FU)

Figure 18 is based on rolling 12-month performance each month over five years (or any time period up to ten years) and shows the percentage of those observations the Fund ranked within each of five quintiles.

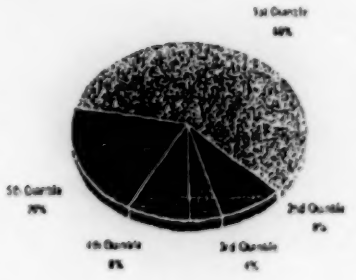

FIGURE 19 ABSOLUTE PERFORMANCE

(FUND)

Figure 19 shows the frequency with which the Fund's total return performance (calculated for each rolling 12 month period monthly over the last five years or since inception) exceeded predetermined performance levels, identified as Hurdle Rates.

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EXHIBIT 14

BEST AVAILABLE COPY

* * * * *

CHICAGO-BASED **Oakmark** employs many of the same techniques as Longleaf, with similar success. Oakmark values companies on their cash-generating abilities and on the going prices for similar companies involved in takeovers or mergers. Although both firms specialize in cheap stocks, Oakmark's managers tend to care a bit more about earnings growth.

Oakmark hires experienced analysts who are committed to value investing and "who have something to prove," says Robert Levy, president of the Oakmark funds. "People here are passionate about winning." Among them is star manager William Nygren, who runs both Oakmark fund and Oakmark Select (the latter is closed to new investors). The product line consists of just seven stock funds with assets of $13 billion.

BEST BETS: *Equity and Income, International, International Small Cap, Oakmark.*

UNDERACHIEVERS: None.

EXHIBIT 16

money

Time Inc.

Money
Time & Life Building
Rockefeller Center
New York, NY 10020-1393

212-522-1212

August 11, 2003

Kelly Arnold
Oakmark Funds
2 North Lasalle Street, Suite 500
Chicago, IL 60602

Dear Ms. Arnold:

It is my pleasure to inform you that **The Oakmark Fund, The Oakmark Equity and Income Fund and The Oakmark International Fund** have been named to the Sixth Annual MONEY 100 -- MONEY magazine's exclusive listing of the world's best mutual funds.

To compile this list of elite funds, MONEY's selection process goes beyond basic performance figures, focusing also on the future potential of the funds and their superb portfolio managers. From MONEY'S point of view, **The Oakmark Fund, The Oakmark Equity and Income Fund and The Oakmark International Fund** have earned their place on the

MONEY 100 in an undeniably challenging time in market history and promises to continue rewarding investors for years to come.

On behalf of the entire MONEY staff, please accept my congratulations.

Sincerely,

/s/ ROBERT SAFIAN

Robert Safian

Managing Editor

EXHIBIT 18

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REUTERS

Reuters News

March 16, 2004 Tuesday 10:00 PM GMT

HEADLINE: FACTBOX – **Fund firms receive Lipper awards.**

BODY:

NEW YORK, March 16 (Reuters) – Four mutual fund families received top honors on Tuesday as Lipper Inc., the research company, held its second annual U.S. fund awards presentation in New York City.

Taking home the evening's top prizes were: American Funds, winner of Best Overall group winner; Undiscovered Managers LLC, Best Equity group winner; Vanguard Group, Best Mixed Equity group; and USAA, best Bond group.

Lipper, a division of Reuters Group Plc., made the presentations at the Reuters Building in Times Square on Tuesday evening.

Below is the list of the 35 funds that Lipper said provided consistently superior returns in their respective groups. Another 71 funds also received certificates from Lipper in smaller fund groups.

INDIVIDUAL BOND FUND WINNERS:

1. First American California Tax-Free Fund;
2. Calvert Social Investment Fund Bond Portfolio;
3. Loomis Sayles Investment Grade Fixed-Income Fund;
4. Eaton Vance National Municipals Fund;
5. RSI Retirement Trust Actively Managed Bond Fund;
6. BlackRock GNMA Portfolio;
7. Loomis Sayles Institutional High Income Fund;
8. PIMCO Investment Grade Corporate Bond Fund;
9. Franklin Federal Intermediate-Term Tax-Free Income;
10. Loomis Sayles Strategic Income Fund;
11. PIMCO Low Duration Fund III; and
12. Phoenix-Goodwin Multi-Sector Short-Term Bond Fund.

INDIVIDUAL MIXED EQUITY FUND WINNERS

1. Oakmark Equity and Income Fund;
2. Federated Market Opportunity Fund; and
3. Franklin Income Fund.

INDIVIDUAL EQUITY FUND AWARDS

1. GMO Emerging Markets Fund;
2. PIMCO NFJ Dividend Value Fund;
3. Oakmark Global Fund;
4. State Street Research Health Sciences Fund;
5. Tax-Managed DFA International Value Portfolio;

6. Victory Portfolios: Diversified Stock Fund;
7. Hartford Growth Fund;
8. American Century Large Company Value Fund;
9. Fidelity Leveraged Company Stock Fund;
10. MFS New Endeavor Fund;
11. Fidelity Advisor Leveraged Co. Stock Fund;
12. MassMutual Focused Value Fund;
13. Thornburg Core Growth Fund;
14. Columbia Strategic Investor Fund;
15. AIM Real Estate Fund;
16. AAL Large Company Index Fund;
17. Baron iOpportunity Fund;
18. Boston Partners Small-Cap Value Ii Fund;
19. William Blair Small-Cap Growth Fund; and
20. Schneider Small-Cap Value Fund.

* * * * *

EXHIBIT 20

MORNINGSTAR.com

[Images Omitted]

Morningstar Fund Managers of the Year 2001

by Russel Kinnel | 01-04-02 | 09:40 AM

None of Morningstar's three Fund Managers of the Year made you rich quick in 2001. We've just suffered through the worst year for the markets in nearly 30 years – leaving most funds in the red. However, in tough times like these, managers really earn their keep. Our Managers of the Year made money for shareholders though the sky was falling and lesser managers were suffering horrendous losses.

When choosing a Manager of the Year, we don't just look for funds that have scored great gains in a single year – or even over the long haul. In addition to prizing a manager's ability to generate exceptional returns, we look for those who have shown a willingness to align their interests with shareholders'. Additionally, we favor those managers who have exhibited the courage to stay with their strategies in order to produce superior risk-adjusted returns in the end.

As it turns out, a surprisingly large number of strong candidates exhibited those qualities in spades in 2001. Three clear themes emerge from the names we selected this year. Not only are all three winners

value managers who prize Benjamin Graham's "margin of safety," but they have all exhibited a willingness to be extremely candid with their shareholders. Finally, they're all experienced hands who reacted with calm amid the squalls of 2001.

Domestic-Stock Manager of the Year

Bill Nygren – Oakmark Select Fund

Bill Nygren's performance in five years at the helm of Oakmark Select OAKLX has been flawless. We've had a tremendous variety of market environments over that span, yet he has surpassed his peers by a wide margin in each year. In 2001, he beat his category average by more than just about any other manager: Oakmark Select returned 19 percentage points more than the typical mid-cap value fund last year, and a full 38 percentage points more than the S&P 500 index. Over the past five years, the fund has returned an annualized 26.75% per year versus 16.08% for the S&P 500. This year's killer picks include H&R Block HRB, Tricon Global Restaurants YUM, and Office Depot ODP.

Over time, Nygren has scored with both typical and nontraditional value picks. Some of his earliest successes were with true-blue value stocks such as First USA and McDonnell Douglas, both of which were taken over at huge premiums to the price Nygren paid for them. Although Nygren doesn't specifically seek takeover targets, it's no surprise that many of his holdings get acquired: He looks for companies that are trading at 60% or less of what a rational businessperson would pay for them. That may seem a recipe for deep-value investing, but Nygren has exhibited more flexibility than the typical value hound. He scored an enormous gain in 1998 with a

bet on biotech giant Amgen AMGN, for example. And when cable stocks took off in the late 1990s, as investors began to consider them backdoor Internet plays, Nygren holdings such as MediaOne posted huge gains.

Nygren has also shown a commitment to shareholders' bottom line. He manages with taxes in mind, and that has enabled shareholders to enjoy nearly all of Oakmark Select's returns, even after paying taxes on distributions. In addition, Oakmark closed Select before it got too big for Nygren's concentrated style.

Finally, Nygren deserves kudos for his contributions to Oakmark Fund OAKMX, which he has helped to turn around since taking over in 2000. He also deserves partial credit for the fund's early record because he served as Harris Associates' director of research until early 1998.

* * * * *

EXHIBIT 21

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SmartMoney

SmartMoney

March 1, 2004

HEADLINE: Great Managers for All Seasons – As the recent fund scandal shows, it's key to know your manager and not just a fund's track record;

Here's our exclusive list of managers who deliver in good times and bad; Plus: Picks and pans of Fidelity and Vanguard pros

BYLINE: By Evelyn Ellison Twitchell

BODY:

By now, you've received them: Your 2003 year-end 401(k), IRA or rainy-day fund statements. You've opened them . . . and smiled. It's been a while since you've seen such heavy-duty growth – like three years! You're feeling kind of good, kind of confident. Yes, the magic is back.

Just remember: With all the major indexes enjoying breakthrough runups last year, it was a cinch to do well. The real challenge is finding fund managers who can make you money – or at least prevent you from losing a bundle – when the markets turn south

again. And we've got a few good ones who can do just that. Eleven managers who can run with the bulls and don't back down from the bears.

To find them, we went to Jim Lowell, who tracks mutual fund managers the way baseball GMs follow aspiring major leaguers. Who's Jim Lowell? Well, in addition to penning the Fidelity Investor newsletter, he maintains a database of more than 11,000 managers at 22,000 funds. The database differs from Morningstar and Lipper in that it compiles managers' track records across all the funds they manage, rather than showing the returns of only a given fund. So it lets Lowell see not only how managers are doing at their current jobs, but also how they did at funds they previously managed.

From his database, Lowell pinpointed 11 managers with extraordinary records over the past five years. They include some you might expect, like value investor Bill Nygren of the Oakmark Funds, and others a little off the beaten path, such as Manu Daftary, manager of Quaker Aggressive Growth. You'll find the complete roster, as well as these winning pros' outlooks for 2004, beginning on page 80.

Lowell and partner Daniel P. Wiener, editor of the Independent Adviser for Vanguard Investors, have made good use of the database in their own work. Together, they run Adviser Investment Management, a Watertown, Mass. based firm that manages nearly $470 million for 800 clients. The database, along with other tools, helps the pair evaluate Fidelity and Vanguard managers for their clients' portfolios and their newsletters' model portfolios.

Do these guys spot what others don't? In 2000 Lowell advised investors to sell Fidelity's Aggressive

Growth (then rated by Morningstar with five stars) when Robert Bertelson took over. Bertelson had underperformed the Nasdaq by more than 40 percentage points while running the Fidelity OTC fund from 1997 to early 2000. "We knew he stunk to high heaven," Lowell says. "He was the worst stock picker I've ever seen at Fidelity." Under Bertelson, the Aggressive Growth fund lost 79 percent of its value from February 2000 through November 2002, lagging its benchmark, the Russell sell Midcap Growth index, by 26 percentage points. Eventually, Bertelson was moved to the Fidelity Asset Manager Income fund. (A Fidelity spokesperson defends Bertelson, saying he had to manage through "arguably the worst market in decades for the aggressive growth style," and his performance managing the equity portion of Asset Manager has been "excellent.")

When Lowell and Wiener can't find a Fidelity or Vanguard manager they like, they use the database to spot good managers outside the two fund giants. Three years ago the database identified Andrew C. Stephens as an adept manager whose Artisan Mid-Cap fund could be used as an alternative to Vanguard's Capital Opportunity fund, which requires a sometimes prohibitive $25,000 minimum investment. Though both funds have since lost about 3 percent, they've outpaced the 17 percent loss of the Russell Midcap Growth index.

Over time such moves have produced a strong track record. According to The Hulbert Financial Digest, which tracks newsletter performance, Lowell's model portfolios posted an average 8.3 percent five-year annualized return through Dec. 31, 2003, outpacing the Wilshire 5000's 0.4 percent annualized return. Wiener's model portfolios, which have been

around longer, boast an average 10-year annualized return of 11.2 percent, versus the Wilshire's 10.6 percent. Both Lowell and Wiener's returns land them in the top 20 percent of mutual fund newsletters Hulbert tracked for the respective periods.

For SmartMoney, Lowell screened for managers who have thrived during the past five years. The period, he argues, was a solid test of a manager's ability, as it encompassed both one of the biggest bull markets and one of the worst bear markets in U.S. history. He averaged the one-, two-, three- and five-year returns relative to an appropriate benchmark for each fund a manager oversaw during the period. Then he factored in the amount of risk the managers took to earn those returns, by looking at their funds' volatility relative to that of their indexes.

The result: a list of 11 managers worth listening to – and investing with – at any time.

* * * * *

Bill Nygren

Oakmark I and Oakmark Select I

Years managing Oakmark: 4

Years managing Oakmark Select: 7

After the market's big run in 2003, value investor Nygren is having trouble finding new stocks to buy. "It wasn't a year that created lots of new opportunities," he says. Nygren looks for stocks selling at least 40 percent below the best price a cash acquirer could pay for the business and still earn a good return. Plus, he wants to own companies that have a combined earnings growth rate and dividend yield that at least matches his estimate of the S&P 500's. As a

result, Nygren has largely avoided tech stocks. That hurt him last year, but his Select fund still ranks in the top 10 percent of the midcap-value category in the past five years, annualized. Nygren is also avoiding deep cyclicals because of their big pension obligations. These days he favors large-cap stocks, which he thinks are reasonably valued relative to smaller stocks. He has big positions in stocks like Yum Brands and First Data. The Select fund is closed to new investors, but Oakmark remains open.

* * * * *

EXHIBIT 22

Reprinted from BARRON'S

August 16, 2004
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Now Starring . . .

Even in rough markets, some fund managers shine

BY CHRISTOPHER C. WILLIAMS

(the following has been excerpted)

* * * * *

For Michael Welsh, who has managed No. 5-ranked **Oakmark Global** Fund since 1999, with recent help from Clyde McGregor, one of the secrets to successful global investing is flexibility. "At any time there's some kind of turbulence in the world, and turbulence leads to opportunity," says Welsh, a Kansas native.

The $1.4 billion fund invests "anywhere in the world, in companies of any size," says Welsh. The managers generally troll for stocks selling at 60% off what they consider their true value. "We buy nothing that doesn't have at least 30% upside potential," Welsh says.

Lately the fund has been investing mostly in Europe; holdings such as **Bulgari**, a luxury-goods maker, and **Diageo**, the beverage giant, account for 45% of assets. But the fund owes some of its performance in the past few years to U.S. companies such as Nova, a payment processor, and **ITT Educational Services**, a for-profit education concern. Welsh lives in Chicago and is a fan of the Cubs. "It's sad to watch them," he says.

A happier sight is Oakmark Global's performance; the fund is up 31% over one year and 17% over three.

* * * * *

Best in Class

▶The managers listed below were ranked No. 1 by Value Line in their respective investment categories. See the table on page 24 for full performance details.

Fund	Investment Objective	Manager
Quaker Aggressive Growth A	Aggressive Growth	Manu Daftary
Oppenheimer Real Asset A	Asset Allocation	Kevin Baum
Oakmark Equity and Income I	Balanced	Clyde S. McGregor
BlackRock Intl Opp Inv A	Foreign Equity	Thomas Callan
Oakmark Global I	Global Equity	Michael J. Welsh
Hussman Strategic Growth	Growth	John P. Hussman
MFS Strategic Value A	Growth / Income	Kenneth J. Enright
WM Equity Income A	Income	Richard E. Helm
Bjurman, Barry Micro-Cap Growth	Small Company	O. Thomas Barry, III

* * * * *

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed Oct. 10, 2006]

MEMORANDUM OF LAW IN SUPPORT OF PLAINTIFFS' OPPOSITION TO DEFENDANT HARRIS ASSOCIATES, L.P.'S MOTION FOR SUMMARY JUDGMENT

* * * * *

ATTACHMENT 8

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs.

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF WILLIAM C. NYGREN

November 17, 2005

---

* * * * *

[83]

* * * * *

BY MR. BRICKMAN:

Q Let me go over a couple points that you brought up, please, sir. You mentioned that you review inflows and outflows?

A Yes.

Q I assume that's some computer-generated report you get first thing in the morning?

A Again, an e-mail report that normally comes before I've left for the office in the morning. I hon-

estly don't know who sends the e-mail; it's just there every day. And it tells how many shares in each fund have been redeemed and purchased, what our net cash in or outflow was, and it's a rare day when that number is significant enough that it requires action, but it does require monitoring.

Q Do you try to keep a certain amount of cash in your funds?

A There is not a magic number that we try to [84] stay at, but we have told investors we are not market timers, so it would be an extremely rare occurrence that we would have more than 10 percent cash in any of the three funds that I am primarily responsible for.

Also you don't want to get too close to zero for a couple of reasons. You would hate to be a forced seller because of redemptions, but also you want to have availability of some cash if new opportunities arise.

I would say in general, most of the funds have around 5 percent cash most of the time.

Q Do you know if there is some credit line that you can access should there be some that rare day when outflows are so great that you require cash and you don't want to sell any of your holdings?

A I know that that credit line exists, yes.

Q Have you ever had to tap into it?

A I don't think so, but we got real close a couple days in the very early days of Oakmark select.

Q This is back in, what, 2000?

A '97, maybe.

* * * * *

131

(7)

Supreme Court, U.S.
FILED
JUN 10 2009
OFFICE OF THE CLERK

No. 08-586

IN THE
Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Writ of Certiorari
to the United States Court of Appeals
for the Seventh Circuit

JOINT APPENDIX
(Volume 2 of 2 – Pages 319-684)

JOHN D. DONOVAN, JR.
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NOTICE

The following documents have been omitted in the printing of this Joint Appendix but may be found in the appendix to the petition for a writ of certiorari in this case:

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UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed Oct. 10, 2006]

PLAINTIFFS' RESPONSE TO DEFENDANT'S STATEMENT OF UNDISPUTED FACTS AND PLAINTIFFS' STATEMENT OF ADDITIONAL FACTS PURSUANT TO LOCAL RULE 56.1

Plaintiffs' Response to Defendant's Statement of Undisputed Facts

1. The Plaintiffs bring this action derivatively on behalf of three of the six mutual funds for which Defendant Harris Associates, L.P. ("Harris") serves as investment adviser – the Oakmark Fund, the Oakmark Equity and Income Fund and the Oakmark Global Fund (collectively, the "Funds").

RESPONSE: Admitted.

2. Plaintiffs bring this action pursuant to Section 36(b) of the Investment Company Act of 1940 ("ICA").

RESPONSE: Admitted.

3. Harris has its principal place of business in Chicago, Illinois. All of its employees are employed in Illinois. The Funds at issue in this action are sold nationwide, including to citizens of Illinois.

RESPONSE: Admitted.

4. Venue is proper in the Northern District of Illinois.

RESPONSE: Admitted.

5. Each of the funds in The Oakmark Family of Funds is a series of Harris Associates Investment Trust, a Massachusetts business trust ("HAIT"), which is governed by a board of trustees.

RESPONSE: Admitted.

6. Each Oakmark fund is a registered investment company under the ICA, 15 U.S.C. § 80a-1 *et seq.*, and Harris serves as investment adviser pursuant to a separate advisory agreement with each Fund.

RESPONSE: Admitted.

7. Plaintiffs Jerry N. Jones and Mary Frances Jones are shareholders of the Oakmark Equity and Income Fund and the Oakmark Global Fund. Plaintiff Arline Winerman is a shareholder of the Oakmark Fund.

RESPONSE: Admitted.

8. For its service as investment adviser, Harris receives a fee from each Fund, calculated as a percentage of that Fund's net assets at the end of the preceding month.

RESPONSE: Admitted.

9. The fee schedule for the Funds is set forth as part of the advisory contract for each Fund and is negotiated and approved each year by the trustees.

RESPONSE: Denied. While the fees schedules for the Funds are set forth in the advisory

contracts for the Funds, the fee schedules were not negotiated at arm's-length or legally approved in compliance with the ICA.

First, Victor Morgenstern, Chairman of the Board of Trustees of the Funds, was an interested person of Harris (and therefore unqualified to serve as a disinterested trustee) because he received compensation from Harris that was tied to Harris's revenues, much of which were derived from fees paid by the Funds. Morgenstern therefore had a direct economic incentive to approve higher fees for the Funds. *See* Pls.' Statement of Additional Facts ("PSAF") at ¶ 31, *infra*.

Second, a majority of the disinterested trustees, including Morgenstern, suffered from numerous debilitating and disqualifying conflicts of interest because of personal and business relationships between the trustees and personnel at Harris. *See* PSAF at ¶¶ 32-38, *infra*.

Third, Harris violated its fiduciary duty by failing to provide all necessary information for the trustees to make an informed decision regarding the fees paid by the Funds and, in some cases, by providing the trustees with false and misleading information. *See* PSAF at ¶¶ 2-10, *infra* (Harris provided false and misleading information regarding its profitability); ¶¶ 13-14, *infra* (Harris failed to provide the trustees with useful and necessary information related to its economies of scale); ¶ 15, *infra* (trustees lacked sufficient information to establish appropriate breakpoints for the fees paid by the Funds); ¶ 24, *infra* (Harris either failed to pro-

vide the trustees with information regarding the services provided to and fees paid by its institutional clients or provided false and misleading information); ¶ 28, *infra* (trustees lacked sufficient information and understanding of fees paid by the Funds to intermediaries that distribute shares of the Funds).

Fourth, Harris unduly dominated the trustees, thereby preventing them from fulfilling their fiduciary duties, and participated in schemes to extract additional monies from the Funds. *See* PSAF at ¶ 14, *infra* (when one trustee attempted to analyze economies of scale, Harris criticized his analysis and failed to provide any insight or assistance, thereby causing the trustees to reject and/or abandon any further attempt to analyze economies of scale); ¶¶ 16-18, *infra* (Harris refused to implement breakpoints in the fee schedules for the Funds that would result in any current fee reductions and threatened to close Funds, or direct resources away from the Funds, if the trustees persisted); ¶ 27, *infra* (Harris extracted additional compensation from the Funds by causing the Funds to pay duplicative commissions for brokerage services); ¶ 29, *infra* (Harris employed artificial and undisclosed accounting methodologies to cause the Funds to pay a greater portion of the fees paid to intermediaries that distribute shares of the Funds).

10. The fee schedule for each of the Funds features "breakpoints," i.e., asset levels at which the fee declines.

RESPONSE: Denied in Part. At the beginning of the relevant damages period, August 17,

2003,[1] the fee schedules for the Oakmark Equity and Income Fund and the Oakmark Global Fund did not contain breakpoints. Only the Oakmark Fund contained breakpoints in its fee schedule. However, these breakpoints were small and set at high levels of assets, such that the Oakmark Fund did not have sufficient assets to reach all of the breakpoints. Specifically, as of September 30, 2003, the Oakmark Fund had $4.791 billion in assets. *See* Statement of Additional Information, Oakmark Family of Funds ("SAI"), Jan. 31, 2004 (HA0006195) [attached as Exhibit D-4], at App. B (HA0006240)]. The fee schedule at the time contained a breakpoint of 10 basis points (0.10%) at $2 billion in assets, an additional breakpoint of 10 basis points (0.10%) at $3 billion in assets, and a final breakpoint of 5 basis points (0.05%) at $5 billion in assets. *See id.* at p. 19.

11. In recent years, the annual contract renewal process resulted in the initiation of additional breakpoints in the fee schedules of the Funds.

RESPONSE: Denied in Part. None of the breakpoints added to any of the Funds since the beginning of the relevant damages period resulted in a decline of fees when they were

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[1] The Court has ruled that Plaintiffs' claims are governed by a one-year damages period, August 17, 2003, to August 16, 2004. Plaintiffs continue to maintain that damages under § 36(b) are not limited to one year and intend to offer evidence of damages after this period in order to preserve their rights. However, for purposes of responding to Defendant's motion for summary judgment, Plaintiffs have limited their response to evidence that is relevant to the one-year damages period.

added. For instance, nominal breakpoints were added to the fee schedules for the Oakmark Equity and Income Fund and the Oakmark Global Fund that became effective November 1, 2003. *See* SAI, Jan. 31, 2004 (HA0006195), at p. 20 [Exhibit D-4]. The first breakpoint for the Oakmark Equity and Income Fund was 5 basis points (0.05%) at $5 billion, with additional breakpoints of 2.5 basis points (0.025%) at $7.5 billion and $10 billion. *See id.* The first breakpoint for the Oakmark Global Fund was 5 basis points (0.05%) at $2 billion, with an additional breakpoint of 5 basis points (0.05%) at $4 billion. *See id.* However, as of September 30, 2003, the Oakmark Equity and Income Fund had less than $5 billion in assets, and the Oakmark Global Fund had less than $2 billion in assets. *See id.* at App. B (HA0006252, HA0006257) [Exhibit D-4]. As of September 30, 2004, just after the end of the relevant damages period, the Oakmark Equity and Income Fund had assets of $8.057, just reaching its second breakpoint, and the Oakmark Global Fund had assets of only $1.361 billion, still not reaching any of its breakpoints. *See* Annual Report, Oakmark Family of Funds, Sept. 30, 2004 [attached as Exhibit D-6], at 24, 32. *See generally* Pls.' Statement of Additional Facts at ¶¶ 15-18, *infra* (discussing breakpoints for the Funds and trustees' efforts and failures to implement breakpoints).

In addition to the nominal breakpoints discussed above, breakpoints were added to the fee schedules for the Oakmark Fund and the Oakmark Equity and Income Fund that became effective November 1, 2004 (after the relevant

damages period). *See* SAI, Jan. 28, 2005 [attached as Exhibit D-5], at p. 18. Breakpoints of 5 basis points (0.05%) were added to the Oakmark Fund at $7.5 billion and $10 billion, and a breakpoint of 5 basis points (0.05%) was added to the Oakmark Equity and Income Fund at $12.5 billion. *See id.* However, as of September 30, 2005, neither the Oakmark Fund ($6.384 billion in assets) nor the Oakmark Equity and Income Fund ($9.805 billion in assets) had reached any of these breakpoints. *See* Annual Report, Oakmark Family of Funds, Sept. 30, 2005 [attached as Exhibit D-7], at 12, 23.

12. The following table summarizes the fee schedule for each of the Funds, as negotiated and approved by the trustees, including the additional breakpoints negotiated and approved by the trustees during 2003 and 2004:

The Oakmark Fund	Equity & Income Fund
First $2.0 billion under mgmt: 1.00%	First $5.0 billion under mgmt: 0.75%
Next $1.0 billion under mgmt: 0.90%	Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2003)*
Next $2.0 billion under mgmt: 0.80%	Next $2.5 billion under mgmt: 0.675% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.75%	Next $2.5 billion under mgmt: 0.65% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2004)*	
Net assets over $10 billion 0.65% *(New breakpoint as of 11/1/2004)*	Net assets in excess of $12.5 billion: 0.60% *(New breakpoint as of 11/1/2004)*

Global Fund
First $2.0 billion under mgmt: 1.00%
Next $2.0 billion under mgmt: 0.95% *(New breakpoint as of 11/1/2003)*
Net assets in excess of $4 billion: 0.90% *(New breakpoint as of 11/1/2003)*

See 2004 SAI at HA 0112536 – HA 0112537 (Ex. 2 to Sept. Blais Decl); 2005 SAI at 18 (Ex. 3 to Sept. Blais Decl).

RESPONSE: Denied in Part. While the chart reflects the current fee schedules for the Funds, the majority of the nominal breakpoints reflected in the schedules are not applicable given the assets of Funds during and after the relevant damages period. *See* Response to Def.'s Statement of Facts ("DSOF") at ¶¶ 10-11, *supra*. In addition, the fee schedules were not negotiated at arms-length or legally approved. *See* Response to DSOF at ¶ 9, *supra*. Specifically with regard to breakpoints, Harris repeatedly resisted the institution of breakpoints and refused to accept breakpoints that would result in actual fee reductions when approved. *See* Pls.' Statement of Additional Facts at ¶¶ 16-18, *infra*. Also, the breakpoints were set according to irrelevant considerations rather than being based on Harris's profits or its costs of providing services. *See id.* at ¶ 15, *infra*.

13. The applicable advisory fees are fully disclosed to shareholders in the Funds' Statement of Additional Information, and the shareholders are able to

redeem their shares at any time should they prefer to invest in a fund with lower fees.

RESPONSE: Denied in part. There are payments made by the Funds to Harris or its affiliates that are not disclosed. For instance, Harris caused the Funds to pay duplicative commissions for brokerage services and employed artificial and undisclosed accounting methodologies to cause the Funds to pay a greater portion of the fees paid to intermediaries that distribute shares of the Funds. *See* Pls.' Statement of Additional Facts at ¶ 27, 29, *infra*. In addition, many shareholders are not free to redeem their shares without incurring search and switching costs. These often take the form of very real and material penalties and hurdles, such as capital gains realizations (taxes) and limitation and restrictions in 401k and similar plans. *See* Declaration of Edward S. O'Neal ("O'Neal Decl.") [attached as Exhibit A-5], at Rebuttal Report ¶¶ 19-22. To the extent the advisory fees are disclosed and shareholders are free to redeem their shares, these facts are irrelevant to Plaintiffs' claims.

14. The annual process of negotiating and approving Harris's advisory contract and fees pursuant to Section 15(c) of the ICA spans several months and involves multiple meetings between Harris and certain of the trustees.

RESPONSE: Denied in part. While the trustees and Harris conduct multiple meetings related to the renewal of the advisory contracts between Harris and the Funds, the fees are not negotiated at arms length or legally approved

in compliance with the ICA. *See* Response to Def.'s Statement of Facts at ¶ 9, *supra*.

15. Much of the trustees' information-gathering and analysis undertaken pursuant to Section 15(c) of the ICA is completed by a Management Contracts Committee of the board, which then makes a recommendation to the full board for consideration. The Management Contracts Committee met five times over the course of five months in 2002, four times over the course of five months in 2003, and four times over the course of the six months prior to the filing of the complaint in this action in August 2004.

RESPONSE: While Plaintiffs admit that the meetings referenced by Defendant took place, Plaintiffs deny that these meeting demonstrate an arms-length negotiation or that the process resulted in legally approved contracts that comply with § 15(c) of the ICA. *See* Response to Def.'s Statement of Facts at ¶ 9, *supra*.

16. The trustees are advised throughout this process by independent, outside counsel from the firm of Bell Boyd & Lloyd.

RESPONSE: Plaintiffs admit that the minutes of the meetings referenced by Defendant indicate that representatives of Bell Boyd & Lloyd attended the meetings; however, the minutes do not establish that Bell Boyd & Lloyd was independent. Even if Bell Boyd & Lloyd was independent, the fees paid by the Funds were not the result of an arms-length negotiation or legally approved. *See* Response to Def.'s Statement of Facts at ¶ 9, *supra*.

17. Each year, Harris provides to the trustees at their request information on a variety of topics: the services provided by Harris to the Funds in exchange

for the fees; the Harris personnel providing those services; the investment performance of the Funds; the profitability of the advisory contracts to Harris, including detailed information about Harris expenses; certain transactions between the Funds and entities affiliated with Harris (e.g., Harris's affiliated broker); benefits accruing to Harris in addition to fees (e.g., use of "soft dollars" to offset the cost of research services); and compliance information, including information about the best execution of portfolio transactions for each Fund, allocation of purchase and sale transactions among broker-dealers and compliance with the Funds' investment restrictions.

RESPONSE: Denied in part. The fees during the relevant damages period were paid by the Funds pursuant to contracts negotiated prior to the May 2004 Request referenced by Defendant in support of this statement of fact. Prior to May 2004, the trustees issued no formal request for information, and much of the information in the Request was not provided. Accordingly, the Request referenced by Defendant is irrelevant to Plaintiffs' claims.

Furthermore, both before and after this Request, Harris failed to provide all necessary information for the trustees to make an informed decision regarding the fees paid by the Funds and, in some cases, provided the trustees with false and misleading information, including the information referenced in Defendant's Statement of Fact. *See* Pls.' Statement of Additional Facts ("PSAF") at ¶¶ 2-10, *infra* (Harris provided false and misleading information regarding its profitability); ¶¶ 13-14, *infra* (Harris failed to provide the trustees with

useful and necessary information related to its economies of scale); ¶ 15, *infra* (trustees lacked sufficient information to establish appropriate breakpoints for the fees paid by the Funds); ¶ 24, *infra* (Harris either failed to provide the trustees with information regarding the services provided to and fees paid by its institutional clients or provided false and misleading information); ¶ 28, *infra* (trustees lacked sufficient information and understanding of fees paid by the Funds to intermediaries that distribute shares of the Funds).

18. The trustees also commission a third-party industry consultant known as Lipper to provide certain requested data. These materials include comparisons of the Oakmark Funds' investment performance, fees, and profitability to those of a peer group of the Funds' competitors. The investment performance figures in the Lipper materials are reported net of the advisers' fees. The Lipper materials also present data on fees in isolation from the net performance figures. The 2004 Lipper report shows total expenses for each Fund as follows: Global Fund was 0.168% below the median for its peer group, the Equity and Income Fund was 0.025% above the median for its peer group and the Oakmark Fund was 0.174% above the median for its peer group.

RESPONSE: Admitted, but irrelevant. The 2004 Lipper Report was provided to the trustees during the contract renewal period for fees paid in 2005 (after the relevant damages period). The Lipper Reports relevant to the renewal periods for the fees paid in 2003 and 2004 show that the Oakmark Fund and the Oakmark Equity and Income Funds compared

unfavorably with their peers. *See* Lipper Report, Harris Associates Investment Trust, June 25, 2002 (HA0082587) [attached as Exhibit C-39], at HA0082599-604 (Oakmark Fund), HA0082682-87 (Oakmark Equity and Income Fund); Lipper Report, Harris Associates Investment Trust, June 6, 2003 (HA0001298) [attached as Exhibit C-40], at HA0001316-21 (Oakmark Fund), HA0001404-09 (Oakmark Equity and Income Fund). Moreover, Harris provides the identical services it provides to the Funds to institutional accounts for much lower fees. *See* Pls.' Statement of Additional Facts ("PSAF") at ¶ 23, *infra*. Harris did not provide this information to the trustees during the relevant damages period. When Harris finally did provide such information, the information was false and misleading. *See* PSAF at ¶ 24, *infra*.

19. The portfolio management services provided by Harris to the Funds include, among others, research, stock selection, portfolio construction, monitoring compliance with investment restrictions, investor conference calls and proxy voting.

RESPONSE: Denied in part. Harris provides portfolio management services to the Funds pursuant to investment advisory agreements. *See* Pls.' Statement of Additional Facts ("PSAF") at ¶ 19, *infra*. "Investor conference call and proxy voting" are not listed as services provided under these agreements. At any rate, Harris provided virtually identical services to its institutional clients. *See* PSAF at ¶¶ 20-22, *infra*.

20. In addition to providing portfolio management services, Harris provides office space, equipment and personnel to the Funds.

RESPONSE: Admitted. However, Harris provides the same resources to its institutional clients. *See* Pls.' Statement of Additional Facts at ¶¶ 20-22, *infra*.

21. Harris also provides additional administrative services to the Funds, such as shareholder communications, including the preparation and distribution of quarterly reports and prospectuses; oversight of third-party service providers, including the transfer agent, custodian and other intermediaries; trustee support, including trustee education and the preparation of materials for board meetings; and risk management. Mgmt.

RESPONSE: Denied to the extent this Statement of Fact implies that all these services are provided under the investment advisory agreements. Administrative, transfer agency, and shareholder services are provided to the Funds under separate agreements, pursuant to which the Funds pay additional fees. *See* Pls.' Statement of Additional Facts ("PSAF") at ¶ 19, *infra*. To the extent Harris provides services under the investment advisory agreements, Harris provides virtually identical services to its institutional accounts. *See* PSAF at ¶¶ 20-21, *infra*. In fact, the cost of any differences in the services provided to the Funds and institutional accounts is de minimis, and the institutional services actually cost more. *See* PSAF at ¶ 22, *infra*.

22. Harris also serves as investment adviser to a variety of non-mutual fund accounts, including

accounts of institutional investors and high net worth individuals. Harris also contracts to provide sub-advisory services to various funds for which other investment advisers act as the primary adviser.

RESPONSE: Admitted.

23. Harris provides a spectrum of advisory services to these various non-mutual fund accounts and the fees charged to these accounts for the advisory services provided to them are generally different from the fees charged to the Funds.

RESPONSE: Admitted.

24. At the request of the trustees, the 15(c) materials also describe which of the services provided by Harris to the Funds are not provided to Harris's non-mutual fund clients.

RESPONSE: While Plaintiffs admit that the trustees receive materials purporting to describe services provided to the Funds that are not provided to Harris's other clients, these materials are false and misleading. The advisory services Harris provides to its non-mutual fund clients are virtually identical to the advisory services Harris provides to the Funds. *See* Pls.' Statement of Additional Facts ("PSAF") at ¶¶ 20-21, *infra*. In fact, the cost to Harris in providing advisory services to its non-mutual fund accounts is actually greater than the cost of providing services to the Funds. *See* PSAF at ¶ 22, *infra*. The materials given to the trustees fail to provide this information and are false and misleading. *See* PSAF at ¶ 24, *infra*. Even Harris personnel have expressed concern over trying to justify the fee discrepancy between Harris's non-mutual fund clients and the Funds. *See* PSAF at ¶ 25, *infra*.

25. For the three year period ended March 31, 2004, the Oakmark Equity and Income Fund generated an average annual return of 12.49%, net of fees, the third best performance during that three year period of the 445 funds in its performance universe, as defined by Lipper, and above its benchmark, the Lipper Balanced Fund Index, which had an average annual return of 3.76%. For the five year period ending March 31, 2004, the Oakmark Equity and Income Fund's average annual net return of 13.91% was the single best performance result of any fund its performance universe, and above its benchmark figure of 3.11%.

RESPONSE: ***See*** **Response to Def.'s Statement of Facts at ¶ 27,** ***infra.***

26. For the three year period ended March 31, 2004, the Oakmark Fund generated an average annual return of 6.22% net of fees, giving it a rank of 12 out of 307 funds in its Lipper performance universe, and placing it above its benchmark, the Lipper Large-Cap Value Index, which had an average annual return of 1.43%. For the five year period ended March 31, 2004, the fund's average annual net return was 5.29%, giving it a rank of 18 out of 224 funds in its performance universe, and above its benchmark figure of 1.22%.

RESPONSE: ***See*** **Response to Def.'s Statement of Facts at ¶ 27,** ***infra.***

27. For the three year period ended March 31, 2004, the Oakmark Global Fund generated an average annual return of 22.36%, net of fees, the single best performance result of any of the 254 funds in its performance universe, as defined by Lipper. This return was above its benchmark, the Lipper Global Fund Index, which had an average annual return of

2.31%. For the four year period ending March 31, 2004, the Oakmark Global Fund's average annual net return of 20.24% was the single best performance result of any fund its performance universe, and above its benchmark, which had an average annual loss of 4.8%.

RESPONSE: Admitted. However, viewing a more relevant period of performance for the Funds reveals a different picture. The relevant damages period is August 17, 2003, to August 16, 2004, and Plaintiffs continue to hold shares in the Funds to the present day. Since roughly the beginning of the damages period to roughly the present (the three year period ended August 31, 2006), the Lipper Rankings for the Funds are as follows: Oakmark Fund – 469 out of 720; Oakmark Equity and Income Fund – 92 out of 447; Oakmark Global Fund – 6 out of 56. The Oakmark Fund in particular has performed poorly and has a Morningstar Rating of only one star. *See* The Oakmark Funds, Fund Ratings and Rankings, Aug. 31, 2006 (http://www.oakmarkfunds.com/opennews.asp?newsid=192&news_from=h#Lipper) [attached as Exhibit E].

28. *Kiplinger's* magazine selected the Oakmark family as one of the ten best no-load fund families on the market in August 2003 and named the Oakmark Fund as one of 25 "all-star" stock funds in May 2004.

RESPONSE: Admitted. The Kiplinger article is irrelevant in that the performance at issue predates the relevant damages period. *See* Response to Def.'s Statement of Facts at ¶ 27, *supra*.

29. *Barron's* and *Money* magazine both named the Oakmark Fund and the Oakmark Equity and Income

Fund to their list of the world's top 100 mutual funds in August 2003.

RESPONSE: Admitted. This Statement of Fact is irrelevant in that the performance at issue predates the relevant damages period. *See* Response to Def.'s Statement of Facts at ¶ 27, *supra*.

30. Fund industry analyst Lipper placed both the Oakmark Global Fund and the Oakmark Equity and Income Fund in its list of 35 funds that "provided consistently superior returns in their respective groups."

RESPONSE: Admitted. This Statement of Fact is irrelevant in that much of the performance at issue predates the relevant damages period. *See* Response to Def.'s Statement of Facts at ¶ 27, *supra*.

31. In a survey analyzing "which fund companies put investors first," *Money* magazine gave the Oakmark family "top marks" for having "especially laudable or innovative policies."

RESPONSE: Admitted. This Statement of Fact is irrelevant in that much of the performance at issue predates the relevant damages period. *See* Response to Def.'s Statement of Facts at ¶ 27, *supra*.

32. Fund industry analyst Morningstar selected William Nygren, the portfolio manager of the Oakmark Fund, as the industry's "Domestic Stock Manager of the Year" for 2001.

RESPONSE: Admitted. This Statement of Fact is irrelevant in that the event at issue predate the relevant damages period. *See* Response to Def.'s Statement of Facts at ¶ 27, *supra*.

33. A March 2004 survey by *SmartMoney* magazine named William Nygren as one of the 11 top fund managers out of 11,000 under consideration.

RESPONSE: Admitted. This Statement of Fact is irrelevant in that much of the performance at issue predates the relevant damages period. *See* Response to Def.'s Statement of Facts at ¶ 27, *supra*.

34. An August 2004 survey by *Barron's* named the managers of Oakmark Equity and Income Fund (Clyde McGregor) and Oakmark Global Fund (Michael Welsh) as the top managers in the industry for their respective investment objective categories. *See* Christopher C. Williams, *Now Starring . . .*, *Barron's*, August 16, 2004, attached as Ex. 22 to Blais Decl.

RESPONSE: Admitted. *See* Response to Def.'s Statement of Facts at ¶ 27, *supra*.

35. The Funds' investment advisory contracts with Harris expressly authorize Harris to utilize its affiliated broker to execute the Funds' transactions.

RESPONSE: Denied in Part. Harris's affiliated broker had no employees, and the brokerage services at issue were provided by Harris personnel, who were already being compensated under the investment advisory agreements with the Funds. At least one senior Harris executive conceded that the arrangement with Harris's affiliated broker was confusing and difficult to justify. *See* Pls.' Statement of Additional Facts at ¶ 27, *infra*.

Plaintiffs' Statement of Additional Facts

Board of Trustees

1. From January 1, 2001 to July 16, 2003, the Board of Trustees for the Oakmark Fund, Equity and Income Fund, and Global Fund ("Funds") was comprised of eight "disinterested" trustees and one "interested" trustee.[2] The disinterested trustees were: Victor Morgenstern (Chairman), Gary N. Wilner, Burton W. Ruder, Marvin R. Rotter, Michael J. Friduss, Allan J. Reich, Thomas H. Hayden, and Christine M. Maki. *See* Statement of Additional Information, Oakmark Family of Funds ("SAI"), Jan. 26, 2001 (HA0052492) [attached as Exhibit D-1], at pp. 18-19; SAI, Jan. 31, 2002 (HA0009880) [attached as Exhibit D-2], at pp. 21-22; SAI, Jan. 29, 2003 (HA0006101) [attached as Exhibit D-3], at pp. 22-23. On July 16, 2003, John Raitt, President and CEO of Harris, was added as an interested trustee. *See* Minutes of Meeting of Bd. of Trustees, July 16, 2003 (HA0002862) [attached as Exhibit C-5], at pp. 20-21; *see also* SAI, Jan. 31, 2004 (HA0006195) [attached as Exhibit D-4], at pp. 23-24. This composition remained in place until Morgenstern resigned as a disinterested trustee effective January 1, 2005. *See* Minutes of Meeting of Governance Committee of the Board of Trustees, Dec. 1, 2004 (IT04386) [attached as Exhibit C-13], at p. 3.

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[2] For purposes of these Statements of Fact, Plaintiffs use the terms "disinterested" and "interested" to describe trustees as they were purported to be in Harris's public disclosures. These terms do not describe the actual disinterestedness, independence, or lack thereof, of the trustees.

Profitability

2. The trustees of the Funds were unable to evaluate the profitability of the Funds to Harris because the information that Harris provided regarding the Funds' profitability was materially misleading and substantially misstated Harris's actual profitability. *See* Harris Associates L.P., Advisers' Profitability Analysis for Years Ended Dec. 31, 2000 to 2003 (HA0010619, HA0005070, HA0001835, HA0000458) [attached as Exhibit C-2]. This profitability information (1) allocated expenses in a manner that over-allocated expenses to large funds, under-allocated expenses to small funds, and masked economies of scale; (2) improperly treated profit sharing payments to the partners at Harris as an expense; (3) impermissibly included marketing expenses; and (4) lacked any outside verification of the methodology or data used and lacked adequate documentation. *See* Declaration of James D. Lamb ("Lamb Decl.") [attached as Exhibit A-4], at Expert Report at 7-16 and Rebuttal Report at 1-4; Declaration of Steve Pomerantz ("Pomerantz Decl.") [attached as Exhibit A-5], at Expert Report 12-13, 14, 22; Declaration of Mercer Bullard ("Bullard Decl.") [attached as Exhibit A-1] at Expert Report ¶¶ 167-77.

3. Harris allocates costs among its lines of business primarily based on headcount, assets and fund revenues. Harris then allocates the costs in each line of business (excluding marketing costs) among funds based on their percent of revenues. *See* Harris Associates L.P. Business Segment Revenue and Expense Determinations Terms Sheet, 2001 to 2003 (HA0143957, HA0143960, HA_S000008573) [attached as Exhibit C-21]; Workpapers (including handwritten notes) for Harris's 2003 Profitability

Analysis (HA0009808) [attached as Exhibit C-17]; *see also* Lamb Report at 10-11 [Exhibit A-4]. Because all pre-marketing expenses are allocated by the percent of revenue each fund generates within its line of business, the pre-marketing profit ratios are identical for all funds within a business line (i.e. domestic and international – with global being a blend of both). *See, e.g.*, Harris Associates L.P., Advisers' Profitability Analysis for Year Ended Dec. 31, 2003 (HA0000458) at HA0000459 [Exhibit C-2] (showing pre-marketing profit margins for all domestic funds as 54.5%, all international funds as 50.2%, and the Global Fund – a blend of domestic and international – as 52.5%); Lamb Report at 11-12 [Exhibit A-4]; Lamb Rebuttal at 2 n.7 [Exhibit A-4]. Profitability results from such an allocation methodology do not accurately portray the consumption of shared expenses or reflect the true cost of activities required to operate a mutual fund. *See* Lamb Report at 10-12 [Exhibit A-4]; Pomerantz Report at 22 [Exhibit A-6]. For instance, large, established funds are portrayed as requiring proportionately more investment management costs than smaller, less mature funds. *See* Lamb Report at 12 [Exhibit A-4]; Lamb Rebuttal at 2 [Exhibit A-4]; Pomerantz Report at 14 [Exhibit A-6]. This resulted in fund-by-fund economies of scale, as evidenced through increasing profit margins as assets grow, being hidden from the trustees for the Funds, rendering the profitability analyses misleading to the trustees of the Funds. *See* Lamb Report at 9-16 [Exhibit A-4]; Pomerantz Report at 14 [Exhibit A-6]; Pomerantz Rebuttal at 4 [Exhibit A-6]; Bullard Report at ¶¶ 175 [Exhibit A-1].

4. Harris's profitability analyses treated the discretionary compensation payments to the partners of

Harris as an expense. This component of Harris's "expenses" is substantial and amounted to 37% of Harris's total mutual fund revenues in both 2002 and 2003. *See, e.g.*, Harris Associates L.P., Advisers' Profitability Analysis for Year Ended Dec. 31, 2003 (HA0000458) at HA0000459 [Exhibit C-2]. However, the vast majority of these compensation payments represent additional profits of Harris and are made as profit-sharing payments. *See* Lamb Report at 13-16 [Exhibit A-4]; Lamb Rebuttal at 3-4 [Exhibit A-4] ("Those employees referred to as partners by HALP are paid a salary plus the remainder of revenues after all company expenses have been paid. The remainder of revenues after expenses have been paid is by definition "profit."); Pomerantz Report at 12-13, 22 [Exhibit A-6] ("Furthermore, the discretionary compensation, referred to above, is not an expense, but rather payments made to partners and, as such, should more rightfully be viewed as an investment return. Simply speaking, it is profit."); Deposition of Michael Neary, July 20, 2005 [attached as Exhibit B-6], at 11-12 ("[T]here is economic benefit to being a partner in the sense of the profitability of the firm you get to share in, . . . kind of a typical profitability pool"); Deposition of John Raitt, Sept. 22, 2005 [attached as Exhibit B-8], at 201 ("[T]here [is] basically a day-to-day market level compensation level as well as some long-term equity ownership incentives, equity-like incentives available to the partners. . . . [T]here may be some ownership-type aspects to being a partner of the firm, and we recognize that."); Minutes of Meeting of Management Contracts Committee, June 6, 2003 (HA0002850) [attached as Exhibit C-9], at pp. 5-6 (Raitt stating that discretionary compensation "consists of a 'profit pool' that is divided among partners and paid out annually" and

that Harris's compensation "reflects the benefits of equity ownership"); Board Materials (with executive handwritten notes) for Meeting of Management Contracts Committee, June 6 2003 (HA0001829-43) [attached as Exhibit C-10], at HA0001830 ("Each year the partners of Harris Associates essentially divide up the profits of the firm . . . . [P]artners 'own' the income stream . . . .").

5. The total compensation of the Harris partners (the vast majority of which – 94% – is made up of discretionary compensation) greatly exceeds the median compensation (including salary, bonuses, and non-cash compensation) in the industry for individuals with the same job responsibilities in similar asset management firms. Total compensation for Harris partners in 2003 was $75 million, or over six times higher than the median figures. *See* Lamb Report at 14-15 [Exhibit A-4]; Lamb Rebuttal at 3-4 [Exhibit A-4]. The annual amounts of the discretionary compensation payments alone increased from $37.6 million in 2000 to $72.5 million in 2003, with individual payments to one partner exceeding $14 million in 2003 and $20 million in 2004 (over 17 times and 25 times the industry average of $793 thousand, respectively). *See* Pomerantz Report at 12-13 [Exhibit A-6]; Harris Associates L.P. Partner Compensation History (HA-N000000041) [attached as Exhibit C-30]; Deposition of William Nygren, Nov. 17, 2005 [attached as Exhibit B-7], at p. 58.

6. Including the discretionary compensation payments made to the partners of Harris as an expense when calculating the profitability of the Funds to Harris greatly misrepresented Harris's profitability to the trustees of the Funds. If the discretionary compensation payments were treated as profits for

purposes of Harris's profitability analyses, Harris's pre-marketing profit margin in 2003 would have been 91% rather than 54%, as reported to the board. *See* Pomerantz Report at 22 [Exhibit A-6]; Harris Associates L.P., Advisers' Profitability Analysis for Year Ended Dec. 31, 2003 (HA0000458) at HA0000458 [Exhibit C-2]. Even if you factor in a reasonable amount of compensation for the partners based on median industry compensation, and treat the remainder as profits, Harris's 2003 pre-marketing profit margins for the Oakmark Fund and the Oakmark Equity and Income Fund would increase from 54.5% to 86.4%, and its pre-marketing profit margins for the Oakmark Global Fund would increase from 52.5% to 78.9%. *See* Lamb Report at 16 [Exhibit A-4]. This does not even take into consideration Harris's flawed allocation methodology, which over-allocates costs to the larger funds. *See* Pls.' Statement of Additional Facts ("PSAF") at ¶ 3, *supra*. If Harris used an appropriate allocation methodology, the profit margins for the Oakmark Fund and the Oakmark Equity and Income Fund would have been even higher.

7. Harris's misrepresentation of the discretionary compensation as an expense influenced the trustees to believe Harris's profitability was lower than it really was. *See* Deposition of Marvin Rotter, Nov. 29, 2005 [attached as Exhibit B-10], at 155-56 (considering all of discretionary compensation to be an expense); Deposition of Burton Ruder, Sept. 26, 2005 [attached as Exhibit B-13], at 144-45. One trustee even stated that whether a given individual received money because it was a share of profits or discretionary compensation or base salary or draw wasn't necessarily important to us." Deposition of Victor

Morgenstern, Sept. 23, 2005 [attached as Exhibit B-5], at 136. Moreover, while Harris attempted to justify the amount of compensation paid to the partners on the ground that the payments were necessary to be competitive in the industry so that Harris could retain investment professionals, the trustees had no basis to evaluate this justification because Harris never provided the trustees with the amounts of individual portfolio manager compensation. Accordingly, the trustees erroneously and baselessly believed that the compensation paid to the partners at Harris was "in line with" industry norms. *See* Deposition of Thomas Hayden, Sept. 12, 2005 [attached as Exhibit B-3], at 135-36 (trustee did not know portfolio manager compensation or whether they were paid more or less than portfolio managers at other companies); Rotter Dep. at 154-58 [Exhibit B-10]; Ruder Dep. at 148-49 [Exhibit B-13] (trustees never received information regarding the amounts of compensation paid to individual partners or how it compared with the industry); Deposition of Gary Wilner, Sept. 13, 2005 [attached as Exhibit B-14], at 236-38 (trustee had no knowledge of Harris's portfolio manager compensation relative to the marketplace and did not know where to find that information). Even when the trustees asked for specific compensation information, Harris refused to provide it because of the supposed "complexity" of the issue and the compensation process. *See* Minutes of Meeting of Management Contracts Committee, Feb. 17, 2004 (HA020454) [attached as Exhibit C-11], at p.2.

8. Harris included marketing expenditures in the profitability analyses given to the trustees of the Funds. *See, e.g.*, Harris Associates L.P., Advisers' Profitability Analysis for Years Ended Dec. 31, 2003

(HA0000458) at HA0000459 [Exhibit C-2] (containing line item for "Subsidiary Level Marketing" expenses). Prior to 2002, the profitability analyses showed fund-by-fund profitability margins only on a post-marketing basis. *See* Harris Associates L.P., Advisers' Profitability Analysis for Years Ended Dec. 31, 2001 (HA0005070) at HA0005071 [Exhibit C-2]. Even after a line for the pre-marketing profit margin was added, however, the profitability analyses created the impression that the relevant profitability percentage for purposes of evaluating Harris's fund-by-fund profitability was the line titled "Profit Margin" (at the bottom of each page) as opposed to the pre-marketing profitability margin, which followed the line of expenses labeled "Subtotal" (implying that it was preliminary or incomplete). *See* Harris Associates L.P., Advisers' Profitability Analysis for Year Ended Dec. 31, 2003 (HA0000458) at HA0000459 [Exhibit C-2].

9. At least two trustees admitted that they considered marketing costs as an expense for purposes of evaluating Harris's profitability. *See* Deposition of Michael Friduss, Sept. 1, 2005 [attached as Exhibit B-2], at 148-49; Hayden Dep. at 201-05 [Exhibit B-3]. Harris executives, and even the trustees' own counsel, repeatedly reinforced the independent directors' consideration of marketing expenses (specifically intermediary payments) in face-to-face meetings with the trustees. *See, e.g.*, Minutes of Meeting of Management Contracts Committee, June 25, 2002 (HA0005056) [attached as Exhibit C-7], at p. 3 (Rowsell explaining that payments made to intermediaries caused Harris's profit margin for the Equity and Income Fund to be "substantially lower than its profit margin for the other funds"); Minutes of Meet-

ing of Management Contracts Committee, July 12, 2002 (HA0005061) [attached as Exhibit C-8], at p. 2 (Cameron Avery, counsel for the trustees, noting that Harris's post-marketing profitability had declined over the past three years, and Rowsell adding that "marketing expenses had steadily increased").

10. The methodology behind the profitability analyses Harris provided to the trustees lacked sufficient documentation and was not independently verified. Nor were the terms' sheets and workpapers associated with the profitability analyses shared with the trustees. *See* Lamb Report at 12 [Exhibit A-4]; Rowsell Dep., June 15, 2005, at p. 140 [Exhibit B-11]. Furthermore, the trustees decided not to obtain an objective evaluation of the profitability analyses. *See* Minutes of Meeting of Management Contracts Committee, May 1, 2002 (HA0005315) [attached as Exhibit C-6], at HA0005317.

Economies of Scale

11. Harris's financial data for the years 1999 to 2003 establish that Harris experienced significant economies of scale in its management of the Funds, that is, the costs to Harris in managing the Funds declined, on a percentage basis, as the assets of the Funds increased. Specifically, the personnel, occupancy and operating costs of Harris's Domestic Mutual Funds business unit and International Group (the majority of the revenues of these business units come from the Funds) all declined substantially with the asset growth of these business units from $5.7 billion to $26.7 billion (the average assets in these business units fell from $8.9 billion in 1999 to $5.7 billion in 2000 and then rose to $26.7 billion by the end of 2003). Furthermore, in 2000, when assets stood at $5.7 billion, personnel, occupancy and oper-

ating costs comprised 41% of total costs. In 2003, when assets grew to $26.7 billion, these costs comprised only 15% of total expenses. *See* O'Neal Report at 8-16 [Exhibit A-5]; O'Neal Rebuttal at 10-11, 14-22 [Exhibit A-5]; source data for costs (HA0009830, HA0138326, HA0138335, HA0138347, HA0138352) [attached as Exhibit C-26]; source data for assets (HA_N000000002, HA_N000000003, HA_N000000048) [attached as Exhibit C-27].

12. A regression analysis of Harris's costs also shows that marginal costs declined as assets grew, which also demonstrates that Harris experienced economies of scale. The cost to manage the first $500 million of assets is $950 thousand, while the cost to manage the second $500 million of assets is only $860 thousand. The cost to manage the tenth increment of $500 million in assets is $750 thousand. *See* Pomerantz Report at 13-15 [Exhibit A-6]. However, little to none of these economies of scale were shared with the shareholders of the Funds. Rather, Harris retained these economies of scale for itself as additional profits. Indeed, Harris's profits increased in direct correlation with asset growth. *See* O'Neal Report at 17 [Exhibit A-5]. For example, as the cost of managing incremental units of assets declined from $950 thousand for the first $500 million in assets to $810 thousand for the fourth $500 million in assets (a decline of 15%), marginal profit increased from $4.05 million, or 81% of revenue, to $4.19 million, or 84% of revenue. *See* Pomerantz Report at 21 [Exhibit A-6].

13. Harris prevented the trustees of the Funds from taking economies of scale into consideration when evaluating the Funds' advisory contracts because Harris failed to provide the trustees with

adequate information regarding its economies of scale. In fact, Harris never provided the trustee with an actual economies-of-scale analysis. *See* Deposition of Kristi Rowsell, June 15, 2005 [attached as Exhibit B-11], at 236-38. Furthermore, the information Harris provided to the trustees regarding its profitability from managing the Funds was misleading, particularly because Harris's methodology for allocating its costs tended to mask the economies of scale inherent in Harris's business. *See* Pomerantz Report at 14 [Exhibit A-6]; PSAF at ¶¶ 2-3.

14. Michael Friduss, one of the disinterested trustees attempted his own analysis of economies of scale. His analysis graphed Harris's revenues and costs and clearly demonstrated that Harris's costs declined as a percentage of revenues as the assets of the Funds grew. *See* Oakmark Economies of Scale (HA0009236-45) [attached as Exhibit C-14]. However, Harris personnel, including CEO John Raitt, were very critical of the analysis. *See* Raitt Dep. at 255 [Exhibit B-8] ("The analysis . . . had several problems with it. There are some basic input errors. There was some errors in methodology and some weaknesses in presentation."); *see also* Rowsell Dep., June 15, 2005, at 233 [Exhibit B-11] ("I remember problems with these graphs having data out of order, for example; and I felt like they were not a fair depiction of the revenues and expense data they were trying to represent."). Harris made some attempt to recreate Friduss's charts, but offered no insight into economies of scale or further assistance in understanding the charts. *See* Raitt Dep. at 258-61 [Exhibit B-11; Friduss Dep. at 119-20 [Exhibit B-2]. Ultimately, the trustees (including Friduss) essentially rejected the analysis and drew no conclusions

from it. *See* Friduss Dep. at 112, 119, 124-131 [Exhibit B-2]; Hayden Dep. at 24, 26, 32 [Exhibit B-3]; Wilner Dep. at 171-73 [Exhibit B-14]. The trustees made no other attempt to determine whether the Funds were experiencing economies of scale and whether such economies of scale were being shared with the shareholders. *See* Rotter Dep. at 96-97, 102 [Exhibit B-10]; Ruder Dep. at 84 [Exhibit B-13]. Nor did the trustees seek assistance from anyone in making such a determination. *See* Friduss Dep. at 121-28 [Exhibit B-2]. In fact, although Friduss claimed to have conducted "much research" on economies of scale, he was completely ignorant of widely publicized studies by the SEC and GAO. *See* Friduss Dep. at 115-18 [Exhibit B-2]. One disinterested trustee even admitted that he did not consider economies of scale realized by Harris. *See* Deposition of Allan Reich, Nov. 11, 2005 [attached as Exhibit B-9], at 135 ("I don't look at specifically revenues – economies of scale that may be realized by the advisor per se.").

Breakpoints

15. While the fee schedules for the Funds contain breakpoints (mostly nominal), the breakpoints in fee schedules for institutional and sub-advisory clients are set at much lower asset levels, thus providing higher discounts to those clients. *Compare* Def.'s Statement of Facts ("DSOF") at ¶ 12 *with* Institutional Account Data (HA0135007-12, HA0135013X-27X, HA0135028A) [attached as Exhibit C-20] *and* Harris Associates Investment Trust, Responses to Information Request, May 2004 (HA0000211) [attached as Exhibit C-1], at Item D.2 (HA0000437-55); *see also* Lamb Report at 20 [Exhibit A-4]. The small breakpoints for the Fund were unrelated to actual economies of scale realized by Harris and were set by

the trustees without reference to Harris's profitability or costs of providing services. *See* Friduss Dep. at 183-84 [Exhibit B-2] ("We don't scientifically know exactly what we're doing when we put those breakpoints in."); *see also* Lamb Report at 20 [Exhibit A-4]. Rather, the trustees looked to irrelevant factors, such as the placement of breakpoints by other mutual fund complexes. *See* Rotter Dep. at 98-100, 103 [Exhibit B-10]. In fact, one trustee even conceded that when it came to setting breakpoints, the trustees would have no idea whether breakpoints were set too high to pass on economics of scale. *See* Friduss Dep. at 184 [Exhibit B-2]. *See generally* Pls.' Resp. to DSOF at ¶¶ 10-12 (breakpoints for the Funds).

16. In 2002, when the trustees of the Funds considered implementing breakpoints for the Equity and Income Fund, the portfolio manager for the Fund, Clyde McGregor, "strongly opposed the addition of breakpoints" and indicated that he would close the Fund rather than decrease Harris's profitability. *See* Minutes of Meeting of Management Contracts Committee, Sept. 11, 2002 (HA0005067) [attached as Exhibit C-33], at p. 2 ("Mr. McGregor strongly opposed the addition of breakpoints . . . [and] indicated that in lieu of implementing breakpoints and decreasing the Adviser's profitability, [he] would rather close the Fund to new investors."). The meeting where McGregor's threat to close the Fund was discussed was attended in person by one disinterested trustee (three others participated by phone) and five Harris executives, including John Raitt (CEO of Harris). Thus, Harris personnel outnumbered the disinterested trustees five to four, and the sole trustee who participated in person five to one. *See id.* at p. 1. Needless to say, no breakpoints were instituted

during this contract cycle. *See* Pls.' Resp. to DSOF at ¶¶ 10-12.

17. In 2003, John Raitt (the CEO of Harris) suggested that instituting breakpoints for the Funds would make them "less attractive" to manage and that Harris would "reserve [its] limited investment capacity for [its] higher fee business." Printed and Handwritten Notes of John Raitt (HA0008958-59) [attached as Exhibit C-34] (also containing handwritten note by someone else stating that Harris would "sell out to highest bidder"); *see also* Handwritten Notes of John Raitt (HA0001879-87) [attached as Exhibit C-35] at HA0001884 (referring to "Profit Maximization" and "shift[ing] efforts to highest net fee bus[iness]"); *id.* at HA0001885 (stating that Harris is a "Profit Maximizer" and that Harris "will close" and "will shift business to institutional"); Raitt Dep. at 236-41, 245 [Exhibit B-8] (explaining notes at HA0001884-85 in the context of a discussion with the trustees about breakpoints in 2003). Raitt openly admitted at his deposition that Harris "would be likely to pursue growth in other businesses and possibly add additional resources to other businesses at the expense of the funds." Raitt Dep. at 41 [Exhibit B-8] (Raitt tried to correct this statement with the meaningless distinction that he meant "in lieu of the funds" rather than "at the expense of the funds").

18. Harris refused to implement any breakpoints that would result in an immediate reduction of fees (or concomitant passing on of economies of scale). Rather, Harris would only agree to breakpoints for future, unrealized asset growth because Harris did not want to reduce its profits, or as one trustee put it at his deposition, Harris's "bottom line." *See* Hayden Dep. at 145-58 [Exhibit B-3]; Wilner Dep. at 166-68

[Exhibit B-14]; *see also* Email Re: Meeting with John Raitt, Sept. 28, 2004 (IT-MF00150) [attached as Exhibit C-32] (expressing Harris's concern with proposed breakpoints that would "impact Harris's profit (discretionary income)"). One trustee expressed his belief that Harris would "not accept any reduction of current fees" and indicated that Raitt told him that Harris was "willing to look at lower breakpoints going forward, but nothing that reduces fees as they [currently stood]." Email Re: Meeting with John Raitt, Sept. 28, 2004 (IT-MF00150) [Exhibit C-32]. Ultimately, the trustees capitulated to Harris as none of the breakpoints added to the fee schedules for the Funds have resulted in current fee reductions. *See* Pls.' Resp. to DSOF at ¶¶ 10-12.

Comparative Fee Structures

19. Pursuant to the investment advisory agreements between Harris and the Funds, Harris provides only investment advisory services, including "manag[ing] the investment and reinvestment of the assets of the Fund[s]," and "plac[ing] all orders for the purchase and sale of portfolio securities for the account of the Fund[s] with brokers or dealers." *See* Investment Advisory Agreements for the Oakmark Fund, Oakmark Equity and Income Fund, and Oakmark Global Fund, Oct. 30, 2000 (HA0015481, HA0015628, HA0015759) [attached as Exhibit C-18], at ¶ 2. The agreements expressly state that other services "are not within the scope of the duties of the Adviser under th[e] agreement[s]" and that the "Adviser (or an affiliate of the Adviser) may receive [other compensation] from the [Funds] for such services in addition to its fee for services as Adviser." *See id.* at ¶ 3. Importantly, the investment advisory agreements do not provide for accounting services,

shareholder services, administrative services, or transfer agency services. Rather, these non-investment services are provided under separate agreements pursuant to which the Funds pay additional fees. See Transfer Agency and Service Agreements (HA0013815-50) [attached as Exhibit C-36]; Custodian Agreement (HA0013462-89) [attached as Exhibit C-37]; Administration Agreement (HA0013448-60) [attached as Exhibit C-38].

20. In addition to providing advisory services to the Oakmark Funds, Harris provides advisory services to a variety of non-mutual fund clients, including pension funds, retirement accounts and subadvisory accounts ("institutional accounts"). The advisory services provided to the institutional and subadvisory accounts are virtually identical to the advisory services provided to the Oakmark Funds. In fact, Harris's research department is managed as a single entity, and the research conducted is used equally by all clients. Indeed, portfolio managers for both the Funds and the institutional accounts are not only given the same research, but attend the same weekly stock selection meetings. There is virtually no difference in the day-to-day management activities between the mutual funds and the institutional accounts, and the same people who manage the institutional accounts contribute to the management of the Oakmark Funds. *See* Deposition of Henry Berghoef, Aug. 30, 2005 [attached as Exhibit B-1], at 35-37, 81-83, 152-156; Deposition of Clyde McGregor, Aug. 31, 2005 [attached as Exhibit B-4], at 35-37; Nygren Dep. at 43 [Exhibit B-7]; Harris Associates Domestic Architecture (HA_S000127570) [attached as Exhibit C-24] at HA_S000127575-77 (describing investment process); Pomerantz Report at 15 [Exhibit

A-6]; Pomerantz Rebuttal at 2-4 [Exhibit A-6]; O'Neal Report at 19-20 [Exhibit A-5]; Lamb Report at 17 [Exhibit A-4]; Lamb Rebuttal at 4-6 [Exhibit A-4].

21. The portfolio holdings of the institutional accounts are consistent with mutual funds that share the same strategy. For example, during a given time period, institutional accounts in Harris's large cap strategy will contain most of, if not all, the same stocks as the Oakmark Fund. *See* Harris Associates Domestic Architecture (HA_S000127570) at HA_S000127577 [Exhibit C-24] ("Our large Cap institutional portfolios consist of approximately 40 stocks (40-50 stocks). The Oakmark Fund, a more diversified portfolio, contains most – if not all – of the same stocks during a given time period."). In fact, Harris's standard response to requests for proposals suggests that clients seeking a large cap strategy can invest in either the Oakmark Fund or separate institutional accounts, identifying minimum account size as the only difference. *See* Harris Associates Domestic Architecture (HA_S000127570) at HA_S000127705 [Exhibit C-24].

22. Any differences between the advisory services provided to the Oakmark Funds and those provided to the institutional accounts are de minimis in terms of their cost to Harris. In fact, even considered in isolation, a conservative estimate of the fully allocated costs (including overhead) of the departmental personnel that provide services to the Funds, but not the institutional accounts, amounts to 1.56 basis points of the Fund assets (0.0156%) (this includes the total costs of the Fund Operations and Fund Accounting Departments). Nonetheless, Harris charges the Funds fees that are 40 to 65 basis points higher than those charged to the institutional accounts. *See*

Lamb Rebuttal at 4-6 [Exhibit A-4]; Pomerantz Rebuttal at 2-4 [Exhibit A-6]; HA0009830 (source data for costs) [Exhibit C-26]; HA_N000000331 (source data for salaries) [attached as Exhibit C-28]; HA_N000000003 (source data for assets) [Exhibit C-27]. Moreover, an examination of all of Harris's costs shows that Harris's institutional business is more costly to Harris than the Funds in relationship to assets under management. In fact, out of Harris's 179 fulltime-equivalent employees (FTEs), only 50 FTEs (28%) are dedicated to the Funds, while 129 FTEs (72%) are dedicated to Harris's other clients. The Funds comprise $17.6 billion (48% – almost half) of Harris's $36.5 billion in assets under management. The fully allocated costs (including overhead) of all FTEs who provide services to the Funds is between 2.8 and 6.5 basis points less than the fully allocated costs (including overhead) of all FTEs who provide services to Harris's other clients. *See* Lamb Rebuttal at 4-6 [Exhibit A-4]; Pomerantz Rebuttal at 2-4 [Exhibit A-6]; HA0009850 (source data for time estimates) [attached as Exhibit C-25]; HA0009830 (source data for costs) [Exhibit C-26], HA_N000000331 (source data for salaries) [Exhibit C-28], HA_N000000003 (source data for assets) [Exhibit C-27].

23. Despite the fact that the advisory services Harris provides to the institutional accounts are virtually identical to those provided to the Oakmark Funds, and despite the fact that the institutional business is more costly to Harris than the Funds, the Funds pay advisory fees that are nearly twice as much or more than the fees paid by the institutional accounts. This is so even though the Funds are all much larger than the institutional and subadvisory accounts. *See* O'Neal Report at 17-20 [Exhibit A-5];

Pomerantz Report at 16-20 [Exhibit A-6]; Lamb Report at 17-21 [Exhibit A-4]; *see also* Institutional Account Data (HA0135007-12, HA0135013X-27X, HA0135028A) [Exhibit C-20]; Harris Associates Investment Trust, Responses to Information Request, May 2004 (HA0000211), at Item D.2 (HA0000437-55) [Exhibit C-1]. If the Oakmark Fund were subject to the same fee schedule as comparable institutional accounts, the effective fee for the Oakmark Fund would be 35.2 basis points, or 52.8 basis points less than what the Oakmark Fund pays. If the Oakmark Equity & Income Fund were subject to the same fee schedule as comparable institutional accounts, the effective fee for the Oakmark Equity & Income Fund would be 25.4 basis points, or 47.6 basis points less than what the Oakmark Equity & Income Fund pays. If the Oakmark Global Fund were subject to the same fee schedule as comparable institutional accounts, the effective fee for the Oakmark Global Fund would be 51.3 basis points, or 48.7 basis points lower than what the Oakmark Global Fund pays. If Harris had charged the Funds fees that were comparable to fees charged to similar institutional accounts, the Funds would have saved between $37 million and $58 million during the damages period. *See* O'Neal Report at 17-20 [Exhibit A-5]; Pomerantz Report at 16-20 [Exhibit A-6]; Lamb Report at 17-21 [Exhibit A-4]; *see also* Institutional Account Data (HA0135007-12, HA0135013X-27X, HA0135028A) [attached as Exhibit C-20]; Harris Associates Investment Trust, Responses to Information Request, May 2004 (HA 0000211), at Item D.2 (HA0000438, HA0000440, HA 0000442) [Exhibit C-1].

24. For purposes of considering and approving the fees paid by the Funds during the relevant damages

period, the trustees of the Funds never received information about the services Harris provided to its other clients or the fees Harris charged to its other clients. The trustees first requested this information on March 31, 2004 (for reviewing fees to be paid in 2005). *See* Letter Re: Harris Associates Investment Trust, March 31, 2004 (HA0009268) [attached as Exhibit C-16], at HA0009270 (trustees requesting a "[c]omparison of [Harris's] management fees for each Fund with fees charged by [Harris] to any other large institutional or other clients with comparable investment objectives"). When Harris finally provided this information, it falsely and misleadingly indicated that Harris provided greater and more costly services to the Funds. *See* Harris Associates Investment Trust, Responses to Information Request, May 2004 (HA0000211) at Item C.1 (HA0000327-31) and Item D.2 (HA0000437-55) [Exhibit C-1]. Harris failed to point out to the trustees that the Funds pay additional fees to Harris or its affiliates for providing many of the services listed by Harris and failed to inform the trustees that the advisory services Harris provides to the institutional accounts are virtually identical to those provided to the Funds and that the institutional business is more costly to Harris than the Funds.

25. Even Harris investment professionals and marketing personnel expressed concern over explaining the fee gap between the Funds and similarly managed institutional accounts. In an email exchange between Bill Nygren, portfolio manager of the Oakmark Fund, and Michael Neary, head of marketing at Harris, Neary stated: "I worry less about the fee gap in sub-advised than I do institutional." Nygren replied: "I'm just worried about trustee relations and

maintaining our existing [mutual] fund fees – it would be nice to be able to answer [the question of whether the mutual fund fees are similar to what other large accounts pay] affirmatively .... And I have suggested to Clyde [McGregor, portfolio manger of the Oakmark Equity and Income Fund,] that as a 'premium manager', he should not be offering to manage new accounts at our normal institutional rates." *See* Email Re: Proposed SEC Rules on Manger Compensation, March 11, 2004 (HA_E0237411) [attached as Exhibit C-22]. In a follow-up email the next day, Neary suggested that if the Funds are compared to accounts with a "similar strategy," then Harris's defense regarding the fee discrepancy "is weak but not zero." He also suggested that another Fund portfolio manager was "in a more difficult situation" because "[h]is institutional accounts are nearly identical and his fee gap approaches 40 [basis points]." *See* Email Re: a few items, March 12, 2004 (HA_E0023970) [attached as Exhibit C-23].

26. A comparison of the performance of the Funds against the performance of composites made up of institutional accounts with the same strategy shows that for the Oakmark Fund and Oakmark Global Fund, investors in the mutual funds have received less return from their investments than institutional investors. From 1999 to 2004, the Oakmark Fund had an annualized return of 6.40% as compared to 10.69% for the composite. From 1999 to 2004, the Global Fund had an annualized return of 17.7% as compared to 19.4% for the composite. While, over this time period, the Oakmark Equity and Income Fund returned 13.1% compared with 11.1% for the composite, the majority of that out performance came from just two quarters rather than any consistency

in the investment process. *See* Pomerantz Report at 23-25 [Exhibit A-6]; Harris Associates L.P. Quarterly Performance Summary (HA0055405) [attached as Exhibit C-19] at HA0055442, HA0055452, HA0055462, HA0055490, HA0055536, HA0055563. However, despite the similarity in performance between the Funds and the institutional accounts, Harris charged much higher fees for advisory services to the Funds.

Duplicative Commissions Paid to Harris

27. During the relevant damages period, the Funds paid millions of dollars in commissions to Harris Associates Securities L.P. ("HASLP"), an affiliated broker, for brokerage services. *See* SAI, Jan. 28, 2005 [attached as Exhibit D-5], at p. 37. HASLP had no employees, and these brokerage services, including trade aggregation, were actually performed by Harris personnel. *See* McGregor Dep. at 196-204 [Exhibit B-4]; Raitt Dep. at 103-106 [Exhibit B-8]. However, Harris was already being compensated to provide services such as trade aggregation as part of the advisory agreements with the Funds. *See* Investment Advisory Agreements for the Oakmark Fund, Oakmark Equity and Income Fund, and Oakmark Global Fund, Oct. 30, 2000 (HA0015481, HA0015628, HA0015759) at ¶¶ 2(b), 4 [Exhibit C-18] (requiring Harris to "place all orders for the purchase and sale of portfolio securities" and to furnish all "personnel necessary to render the[se] services"). Essentially, the Harris traders exercised their discretion to place orders with HASLP by "switching hats" and assuming their role as HASLP brokers. In effect, Harris personnel placed the orders with themselves and received brokerage commissions on top of the advisory fees they were already receiving. *See* McGregor Dep. at 196-204 [Exhibit B-4]; Raitt Dep.

at 103-106 [Exhibit B-8]; *see also* Bullard Report at ¶¶ 30-36 [Exhibit A-1]. Clyde McGregor, a senior portfolio manager at Harris, conceded that Harris's arrangement with HASLP was confusing and difficult to justify. *See* McGregor Dep. at 200 [Exhibit B-4] ("[I]t's something that confused me from time to time – the day I first became a portfolio manager in 1986, and I'm still confused with it now. . . ."); *id.* at 197 ("Well you had one pool of trades that was being done, Merrill Lynches of the world, another pool of trades that was being done through Harris Associates Securities, and it was becoming ever more difficult to – explain that, frankly."). The trustees of the Funds were unaware that HASLP had no employees and that the work was actually performed by Harris personnel. *See, e.g.*, Wilner Dep. at 134-36 [Exhibit B-14].

Illegal Use of Fund Assets for Distribution

28. Fees paid to intermediaries who distributed shares of the Funds were paid in part by the Funds. These fees were paid to the intermediaries for both shareholder services and marketing and distribution services. *See* Minutes of Meeting of Management Contracts Committee of the Board of Trustees, July 12, 2002 (HA0005061), at p. 4 [Exhibit C-8] ("[T]he fees covered marketing, distribution and shareholder servicing expenses incurred by the intermediary on behalf of the fund"); *see also* Morgenstern Dep. at 238-40 [Exhibit B-5]. The Funds paid 43% of the fees paid to the intermediaries subject to a cap based on fees paid to the affiliated transfer agent. *See* Memo Re: Evaluation of Agreement to Allocated Service Provider Fees, June 18, 2003 (HA0003323) [attached as Exhibit C-3]. However, the 43%-split was not based on the actual expenses of the intermediary

incurred for shareholder servicing, and the trustees of the Funds made no effort to determine (and often did not understand) what portion of these fees reimbursed intermediary expenses related to marketing and distribution rather than shareholder servicing. *See* Friduss Dep. at 154-55 [Exhibit B-2]; Hayden Dep. at 116-17, 160-63 [Exhibit B-3]; Reich Dep. at 170-79 [Exhibit B-9]; Rotter Dep. at 20-21, 175-82 [Exhibit B-10]; Ruder Dep. at 191-97, 203-05 [Exhibit B-13]. Moreover, Victor Morgenstern, who was responsible for setting up the agreements with the intermediaries before he resigned from Harris, did not know what portion of the intermediary fee applied to marketing and distribution. He just assumed that the transfer agent fees paid to the Funds' affiliated transfer agent reflected a reasonable fee to pay to third-party intermediaries without conducting an inquiry into the actual nature or cost of the intermediary services. *See* Morgenstern Dep. at 239-40 [Exhibit B-5].

29. The Funds paid 43% of the fees paid to intermediaries who distributed shares of the Funds and were reimbursed by Harris to the extent that 43% exceeded what the Funds would have paid to the affiliated transfer agent. *See* Memo Re: Evaluation of Agreement to Allocated Service Provider Fees, June 18, 2003 (HA0003323) [attached as Exhibit C-3]. However, unbeknownst to the trustees for the Funds, Harris endeavored to reduce the amount of the reimbursements by using undisclosed accounting methodologies so that the Funds would pay as much as possible. *See* Memo Re: Intermediary Profitability Review, March 12, 2004 (HA0009789-801) [attached as Exhibit C-15], at HA0009790 (item 3) ("Re Schwab and Fidelity, HALP had done all that it could to

reduce reimbursements by taking Fidelity Global accounts omnibus and using average account size for accounts where participant numbers did not make sense."). The trustees of the Funds were unaware of these efforts, and at least one trustee conceded [after the fact] that Harris's activities were wrongful. *See* Wilner Dep. at 174-86 [Exhibit B-14]; *see also* Reich Dep. at 172 [Exhibit B-9]; Rotter Dep. at 20, 183-89 [Exhibit B-10].

Soft Dollars

30. As part of a practice known as "soft dollars," Harris spent millions of dollars of Fund assets on commissions during the relevant damages period in return for research products and services that benefited Harris. For instance, for the 12-month period ending September 30, 2004, the Funds paid nearly $3 million in soft dollar commissions. *See* SAI, Jan. 28, 2005, at p. 38 [Exhibit D-5]. While Harris reported the amount of the soft dollar commissions, it never reported the value of the products and services obtained with soft dollars to the trustees of the Funds. *See* SAI, Jan. 29, 2003 (HA0006101), at p. 33 [Exhibit D-3] ("The extent, if any, to which the obtaining of such information may reduce the expenses of the Adviser in providing management services to the Funds is not determinable."); *see also* Bullard Report at 163-66 [Exhibit A-1]. The value of the products and services obtained with soft dollars was approximately $2.3 million. Without the use of Fund assets, Harris would have had to pay for these products and services out of its own pocket. Bullard Report at 74-76 [Exhibit A-1].

Trustee Conflicts

31. Prior to January 1, 2001, Morgenstern was a partner and executive of Harris. *See* SAI, Jan. 31, 2004 (HA0006195) at p. 23 [Exhibit D-4]. Effective January 1, 2001, Morgenstern retired from Harris and became a "disinterested" trustee of the Funds as well as Chairman of the Board. *See* Minutes of Board of Trustees, Jan. 17, 2001 (HA0010794) [attached as Exhibit C-4], at pp. 5-6. At this time, Morgenstern began receiving "deferred" compensation from Harris ("C Plan Compensation") that was subject to reduction based on certain limits associated with Harris's revenues, much of which are derived from the Funds. *See* Harris Associates L.P. Summary of C Plan Provisions (HA_N000000068) [attached as Exhibit C-31]; Morgenstern Dep. at p. 16-19 [Exhibit B-5]; Deposition of Kristi Rowsell, Nov. 28, 2005 [attached as Exhibit B-12], at pp. 88-92. For example, in 2001 (Morgenstern's first year of eligibility for C Plan Compensation) Morgenstern received less than his targeted amount because Harris's revenues in 2001 were not sufficient to entitle him to the entire $632,125. *See* Rowsell Dep. (Nov. 28, 2005) at pp. 89-92 [Exhibit B-12]; Partner Compensation History (HA_N000000041) [attached as Exhibit C-30]. Other participants in the C Plan who received C Plan Compensation while Morgenstern was a trustee for the Funds include Anita Nagler, Roxanne Martino, Anita Rosenberg, and Sherwin Zuckerman, all former partners of Morgenstern at Harris. *See* Lapsing Schedule of Deferred Payees (HA_N000000039) [attached as Exhibit C-29]; Partner Compensation History (HA_N000000041) [Exhibit C-30]. *See generally* Bullard Report at ¶ 95 [Exhibit A-1]; Declaration of Lyman Johnson ("John-

son Decl.") [attached as Exhibit A-3], at Report at 14-16; Declaration of Tamar Frankel ("Frankel Decl.") [attached as Exhibit A-2], at Report at 3-4.

32. Morgenstern, both while he was a partner at Harris and after he retired and became a "disinterested" trustee of the Funds, maintained very close personal and business relationships with other trustees of the Funds. Morgenstern, Wilner, and Ruder have been close friends and neighbors for many years. They have children who are contemporaries, they have vacationed together on many occasions, and Wilner is a trustee of one of Morgenstern's family trusts. *See* Morgenstern Dep. 64-65, 69-71 [Exhibit B-5]; Wilner Dep. 42, 57, 75-77 [Exhibit B-14]; Ruder Dep. 29-35 [Exhibit B-13]. Morgenstern and Wilner formed an investment partnership called Bear East Partners approximately 10 years ago (worth about $200,000 when it was liquidated last year), which traded through Harris and may have invested in common vehicles with current and former Harris partners. *See* Morgenstern Dep. 33-38 [Exhibit B-5]; Wilner Dep. 43-48 [Exhibit B-14]. Morgenstern and Wilner have also invested together in BioSante, Valor Equity Partners, and real estate, including vacation property in Colorado (worth about $1 million) and property in Wisconsin that they bought for $600,000 and sold in 1999 to a then-partner at Harris for $2.25 million. *See* Morgenstern Dep. 54-56 [Exhibit B-5]; Wilner Dep. 49-50, 71 [Exhibit B-14]. Morgenstern has invested together with Ruder in BioSante, Valor Equity Partners, and Super Cerca, which Morgenstern introduced to Ruder. *See* Ruder Dep. 36, 38-39 [Exhibit B-13]. Morgenstern has also been close friends with Friduss since 1960, and Friduss' brother, Jarvis, was Morgenstern's personal

accountant for several years. *See* Morgenstern Dep. 51-52, 63-64 [Exhibit B-5]; Wilner Dep. 79 [Exhibit B-14]; Friduss Dep. 21-23 [Exhibit B-2]. Morgenstern personally recommended Wilner, Ruder, and Friduss as "disinterested" trustees of the Funds. *See* Morgenstern Dep. 62-63, 67-68 [Exhibit B-5]; Wilner Dep. 77, 79 [Exhibit B-14]; Ruder Dep. 29 [Exhibit B13]; Friduss Dep. 21 [Exhibit B-2]. *See generally* Bullard Report at ¶¶ 97, 101, 105-10, 117 [Exhibit A-1]; Johnson Report 14-15 [Exhibit A-3]; Frankel Report 5 [Exhibit A-2].

33. After Morgenstern became a "disinterested" trustee, he maintained close personal and business relationships with Harris. For example Morgenstern is a close friend of Sherwin Zuckerman (a former Harris partner who retired a year after Morgenstern) and has had numerous common investments with him, including, among others, BioSante and Valor Equity Partners. *See* Morgenstern Dep. 57, 59, 66, 68-69, 71, 74, 105-07, 115 [Exhibit B-5]. As detailed below, other Harris partners also invested in BioSante and Valor Equity Partners. In addition, Morgenstern has invested millions of dollars in (and received discounted fees on) hedge funds managed by Harris Alternatives (an affiliate of Harris), revenues of which contribute to the C Plan Compensation. *See* Morgenstern Dep. 20-21, 74, 84-85, 91-92, 103 [Exhibit B-5]. *See generally* Bullard Report ¶ 99 [Exhibit A-1].

34. Morgenstern has been a director and substantial shareholder in a company called BioSante Pharmaceuticals, Inc., since the late 1990s. *See* Morgenstern Dep. 46 [Exhibit B-5]. Morgenstern has over $2 million invested in BioSante. Others who invested in BioSante while Morgenstern was still a

partner at Harris include at least two of his partners (Zuckerman and Anita Nagler – also C Plan participants), three of the disinterested trustees for the Funds (Wilner, Ruder, and Rotter), and one trustee's brother, all of whom learned about BioSante from Morgenstern. *See* Morgenstern Dep. 30-31, 46-50, 53 [Exhibit B-5]; Wilner Dep. 59-60 [Exhibit B-14]; Ruder Dep. 36-38, 49 [Exhibit B-13]; Rotter Dep. 60-61, 57-59 [Exhibit B-10]. *See generally* Bullard Report ¶¶ 98, 102 [Exhibit A-1]; Frankel Report 5 [Exhibit A-2].

35. In 2002 Morgenstern founded Valor Equity Partners, a private equity investment partnership that attracted about 30 investors. Morgenstern has invested over $2 million in Valor, and his son is employed by Valor. Three partners at Harris (Nagler, Roxanne Martino and Anita Rosenberg) and one former partner (Zuckerman) invested in Valor. Three disinterested trustees of the Funds (Wilner, Ruder, and Rotter) also invested in Valor. All of these co-investors were invited into Valor by Morgenstern. *See* Morgenstern Dep. 10-11, 29-32, 49, 95 [Exhibit B-5]; Wilner Dep. 50-51, 71-72 [Exhibit B-14]; Ruder Dep. 36, 40 [Exhibit B-13]; Rotter Dep. 50-51 [Exhibit B-10]. *See generally* Bullard Report ¶ 96 [Exhibit A-1]; Johnson Report 16 [Exhibit A-3]; Frankel Report p. 4 [Exhibit A-2].

36. Other trustees with close personal and business relationships with Harris personnel include Rotter and Reich. Rotter has been friends with Zuckerman for 20 years, was (and is) a client of his, and Zuckerman is married to Rotter's cousin. Rotter and Zuckerman have invested together in numerous vehicles, including BioSante and Valor Equity Partners. Zuckerman recommended Rotter as a trustee

of the Funds. *See* Rotter Dep. 44-51, 54-57, 65, 70 [Exhibit B-10]. Reich has provided legal representation for former and current Harris partners and has maintained a close relationship with Robert Levy (a Harris partner), who manages an IRA for Reich. Levy recommended Reich as a trustee of the Funds. *See* Reich Dep. 9-10, 12-17, 20, 33 [Exhibit B-9]. *See generally* Bullard Report ¶¶ 112-13, 115 [Exhibit A-1]; Johnson Report 16 [Exhibit A-3]; Frankel Report 5-6 [Exhibit A-2].

37. Several of the disinterested trustees of the Funds were aware that Morgenstern received compensation from Harris but nonetheless approved of his serving as a "disinterested" trustee subject to the false notion that Morgenstern had "severed all his formal and financial ties to the advisors and was truly independent." *See* Minutes of Meeting of the Governance Committee of the Board of Trustees, October 21, 2003 (HA128740) [attached as Exhibit C-12], at p. 4; Wilner Dep. 37, 40-41 [Exhibit B-14] (Wilner knew that Morgenstern received compensation from Harris but did not know how it was calculated or that it was tied to Harris's revenues); Ruder Dep. 61, 64-66 [Exhibit B-13] (Ruder knew of compensation but was not aware that it could be affected by Harris's revenues); Reich Dep. 38 [Exhibit B-9] (Reich knew of compensation); Friduss Dep. 46-51 [Exhibit B-2] (Friduss knew of compensation and that it was related to Harris's profits and connected to the fees paid by the Funds, but Friduss did not believe that this created even an appearance of a conflict). In addition, the trustees were aware of the other conflicts involving Morgenstern. *See* Rotter Dep. 51-52, 66 [Exhibit B-10] (Rotter was aware of Morgenstern's interest in Valor and of the real estate

investments by Wilner and Morgenstern); Reich Dep. 27-28 [Exhibit B-9] (Reich was aware of the real estate investments by Wilner and Morgenstern); Ruder Dep. 46 [Exhibit B-13] (Ruder was aware of the real estate investments by Wilner and Morgenstern); *see also* Wilner Dep. 52-53, 60 [Exhibit B-14] (Wilner was aware of Zuckerman's interest in Valor and Ruder's interest in Valor and BioSante). However, the independent trustees never investigated these conflicts. *See* Ruder Dep. 58 [Exhibit B-13] (Ruder stating that board was not kept apprised of common investments between the trustees and Harris).

38. Neither Morgenstern's C-Plan compensation nor his investments in hedge funds managed by a Harris affiliate were ever disclosed in the registration statements for the Funds. *See* SAIs, Jan. 26, 2001 (HA0052492) [Exhibit D-1], Jan. 31, 2002 (HA0009880) [Exhibit D-2], Jan. 29, 2003 (HA0006101) [Exhibit D-3], Jan. 31, 2004 (HA0006195) [Exhibit D-4], Jan. 28, 2005 [Exhibit D-5].

Respectfully submitted,

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October 10, 2006

EXHIBIT A-1

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DISCLOSURE OF EXPERT TESTIMONY

MERCER E. BULLARD

I have been listed as an expert witness in the above-captioned matter on behalf of the plaintiffs. I have set forth below all of the disclosures that I am able to make as of January 30, 2006, in accordance with Rule 26(a)(2)(B) of the Federal Rules of Civil Procedure.

The information in this disclosure is based, in part, on my general experience with the mutual fund industry and mutual fund regulations. I am currently an Assistant Professor of Law at the University of Mississippi School of Law. I have taught courses on the law of banking, contracts, corporations, corporate finance and securities. I also am currently the president of Fund Democracy, which is a 501(c)(3), non-profit membership organization that I founded in

January 2000. Fund Democracy acts as an advocate and information source for mutual fund shareholders. Through Fund Democracy, I have, among other things, lobbied regulators and published articles on a variety of mutual fund regulatory and operational issues. I also have testified before House and Senate committees on the mutual fund scandal, mutual fund reform proposals, 529 plans, and systematic investment plans.

Prior to forming Fund Democracy, I was an Assistant Chief Counsel in the Division of Investment Management in the Securities and Exchange Commission ("SEC" or "Commission"). The Division is responsible for the regulation of investment companies (the mutual funds that are the subject of this litigation are a type of investment company) and investment advisers. I supervised a staff of 8 attorneys in connection with: providing interpretive guidance under the Investment Company Act and the Investment Advisers Act; developing Commission positions under these statutes; and providing general assistance to the securities industry, the public and the Commission relating to these statutes, such as commenting on proposed legislation and rules, responding to regulatory inquiries, and drafting Commission testimony and speeches. Prior to working at the Commission, I was an attorney in the securities practice of Wilmer Cutler Hale & Dorr (then known as Wilmer, Cutler & Pickering) in Washington, DC, where I concentrated on advising investment advisers and broker-dealers regarding the federal securities laws. I have provided consulting and expert services on a variety of mutual fund and investment adviser matters.

Thus, I have had general experience with mutual fund regulatory and operational issues over a number of years as an advocate, journalist, academic, regulator, private practitioner, consultant and expert witness. Through this experience, I have become familiar with SEC releases and other SEC publications, case law, and other sources of law as related to the regulation and operation of mutual funds. In preparing this Expert Report and the opinions and analysis contained therein, I have generally relied on this experience.

STATEMENT OF ALL OPINIONS TO BE EXPRESSED AND THE BASIS AND REASONS THEREFOR

EXPERT REPORT

Executive Summary

1. ***In my opinion, Harris Associates, L.P. ("Harris" referring generally to the entity or the entity and its affiliates) violated its fiduciary duty under Section 36(b) of the Investment Company Act with respect to fees that it and its affiliates received from the Oakmark Fund, Equity & Income Fund, and Global Fund (hereinafter collectively, "Funds").***

2. Section 36(b) of the Investment Company Act of 1940 ("Act" or "ICA") provides that a mutual fund's investment adviser "shall have a fiduciary duty with respect to" compensation it receives from the fund. Harris violated its fiduciary duty under Section 36(b) with respect to the fees charged to the Funds.

3. Harris violated its fiduciary duty under 36(b) on four grounds. First, Harris violated its fiduci-

ary duty by charging the Funds twice for trading services. Second, Harris violated its fiduciary in connection with the Funds' payments to intermediaries. Third, Harris violated its fiduciary duty by charging excessive fees as interpreted according to the *Gartenberg* standard. Fourth, Harris violated its fiduciary duty by charging excessive fees and failing to disclose material information to the Funds' directors in violation of a common law fiduciary duty standard.

4. Harris charged separate commissions to the Funds for trades executed by Harris personnel. These personnel were already obligated to provide such trading services pursuant the Funds' advisory contracts with Harris. Harris thereby violated its fiduciary duty by charging the Funds twice for the same trading services.

5. Mutual funds are not permitted to use their own assets to pay for distribution. Harris caused the Funds to make payments to intermediaries that provided distribution services without providing the board with a reasonable basis to conclude that the payments were for non-distribution services. Harris violated its fiduciary duty by not taking steps to ensure that the Funds did not pay intermediaries for distribution services.

6. The *Gartenberg* and common law fiduciary duty grounds that form the basis of Harris's third and fourth Section 36(b) fiduciary duty violations are based on alternative interpretations of the nature and scope of the Section 36(b) fiduciary duty. As discussed further below, courts generally have held that a section 36(b) plaintiff

must show that the fees charged were "so disproportionately large that [the fees] bear no reasonable relationship to the services rendered and could not have been the product of arms-length bargaining." *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982). This standard is based on the *Gartenberg* case, which set forth a number of factors that should be considered in evaluating the legality of an adviser's fees under Section 36(b), and is generally referred to as the *Gartenberg* standard. This Report also considers whether Harris violated its Section 36(b) fiduciary duty under a common law fiduciary standard, as opposed to the *Gartenberg* standard.

7. This Report does not address which is the appropriate standard under Section 36(b) – the *Gartenberg* standard or the common law fiduciary standard – but rather addresses whether Harris violated its fiduciary duty under either or both. To a significant extent, the two standards overlap. In my opinion, Harris violated its fiduciary duty under both standards, regardless of which one is deemed to be correct as a matter of law.

8. Applying the *Gartenberg* standard, it is my opinion that Harris violated its Section 36(b) fiduciary duty. The Funds experienced substantial economies of scale, but Harris's fees did not adequately share these economies of scale with the Funds' shareholders. Harris also charged higher fees to the Funds than to its institutional clients for similar services. The nature and quality of services provided to the Funds did not justify this disparate treatment or the withhold-

ing of the benefits of economies of scale from the Funds' shareholders. Nor is there any evidence that Harris's fees were reduced to reflect ancillary, "fall-out" benefits that it received as a result of its relationship with the Funds. Finally, the independent directors had numerous and varied conflicts of interested that rendered them incapable, as a group, of conducting an arms-length negotiation with Harris. One independent director did not qualify as an independent director under the Act, four independent directors (including the disqualified director) had numerous material business, professional and social relationships with Harris and Harris partners. A fifth independent director had significant business and social relationships with Harris partners. Harris violated the federal securities by not ensuring that these conflicts were disclosed to the Funds' shareholders, and some of these violations are ongoing as of the date of this Report. In addition, even if the independent directors had been capable of conducting an arms-length negotiation, they did not have information necessary to carefully and conscientiously evaluate the Funds' fees paid to Harris. This was due primarily to Harris's failure to provide the independent directors' with the information necessary for such an evaluation, notwithstanding that Harris was required to do so under Section 15(c) of the Act.

9. Applying a common law fiduciary standard, it is my opinion that Harris violated its Section 36(b) fiduciary duty on two, independent grounds. First, Harris violated its fiduciary duty by fail-

ing to inform the directors or the shareholders of all information necessary to evaluate the fairness of the fees that it charged, as Harris was required to do under Section 15(c) of the Act. Second, Harris violated its Section 36(b) fiduciary duty under a common law fiduciary standard by charging fees to the Funds that were excessive and unfair.

10. The foregoing opinions, and the analysis and opinions expressed in this Report, are based on the information that I have reviewed as of this date. I have not reviewed every document produced or every deposition taken pursuant to this litigation. Rather, I have reviewed the documents and depositions listed below in "Data or Other Information Considered by the Witness in Forming the Opinions." These documents are referred to in this Report as the "Record," in the sense that they reflect the record on which my opinions are based, and not the complete record as reflected by all documents produced and depositions taken pursuant to this litigation. In addition, there may be depositions, outstanding discovery requests and motions to compel discovery that may yield new information that is relevant to my opinion and analysis. Further, plaintiffs, or other expert witnesses, may generate additional analyses. This new information and analyses may be relevant to my opinions and analysis. Accordingly, I may amend this Report after this date to reflect such new information or analysis.

* * * * *

I. Duplicative Commissions Paid to Harris

30. ***Harris violated its fiduciary duty to the Funds by charging them twice for trading services provided by Harris trading personnel.***

31. Paragraph two of the Funds' advisory agreements provided that Harris "shall place all orders for the purchase and sale of portfolio securities for the account of the Fund with brokers or dealers selected by the Adviser." Oakmark Fund Advisory Agreement, ¶ 2 (October 30, 2000). The agreements also stated that Harris:

> shall furnish to the Trust, at its own expense, such office space and all office facilities, equipment and personnel necessary to render the services set forth in paragraph 2 above. The Adviser shall also assume and pay all expenses incurred by it related to the placement of securities orders, and all expenses of marketing shares of the Trust.

See id. at ¶ 4. The Advisory Agreement also stated that Harris or an affiliate may act as broker and receive commissions therefore. *See id.* at ¶ 3.

32. The Funds paid substantial commissions to Harris Associates Securities ("HASL"), a Harris affiliate, as illustrated in the following table:[1]

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[1] *See* Statement of Additional Information, Harris Investment Trust, at 37 (Jan. 28, 2005); Statement of Additional Information, Harris Investment Trust, at 33-34 (Jan. 29, 2003).

Fund	2001 Commissions Paid to HASL (% total commissions)	2002 Commissions Paid to HASL (% total commissions)	2003 Commissions Paid to HASL (% total commissions)
Oakmark	$2,113,214 (33%)	$1,944,752 (29%)	$951,978 (21%)
Equity and Income	$447,443 (45%)	$789,756 (17%)	$845,629 (22%)
Global	$51,708 (23%)	$197,233 (22%)	$171,703 (10%)

33. HASL had no employees; its services were provided by Harris trading personnel. *See* McGregor at 200; Raitt at 109-110. Harris traders, when acting in their capacity as HASL brokers, sent orders to a clearing firm on the floor of the New York Stock Exchange "for credit to Harris Associates Securities." *See* McGregor at 201. Harris used HASL in order to "aggregate execution into a single block" and thereby avoid signaling traders regarding the trades. *See* Raitt at 106. At least one portfolio manager did not understand what services HASL provided, *see* McGregor at 201 ("it's something that confused me from time to time – the day I first became a portfolio manager in 1986, and I'm still confused with it now"), and he expressed concerns that using HASL rather than an outside broker could not be justified. *See id.* at 197 (HASL was closed because it "was becoming ever more difficult to explain" why Harris "had one pool of trades that was being done, Merrill Lynches of the world, another pool of trades that was being done through Harris Associates Securities"); *see also* Wilner at 135-36 (independent director did not know whether HASL actually had any employees or whether trades

effected by HASL were actually effected by Harris employees).

34. The likely reason that the portfolio manager was confused is that the Harris traders who executed trades for HASL as HASL brokers were already obligated as Harris traders to provide order placement services under paragraphs two and four of the advisory contracts. The order aggregation function described by Raitt in the preceding paragraph is a standard service provided by a portfolio manager's trading desk. The traders for an investment adviser will often receive multiple orders from different clients of the firm, or one large order for a single client, that necessitates allocating an order among different brokers and/or electronic trading networks to obtain best execution. The order aggregation services that Raitt described are precisely what the Harris trading desk was compensated for doing under the advisory contracts, yet Harris charged the Funds twice by charging commissions for these services in addition to advisory fees.

35. In addition, it is my opinion that the placement of orders with a clearing firm on an exchange floor, as described by McGregor (who in 20 years was unable to determine exactly what services HASL brokers provided), also would fall under the rubric of paragraphs two and four of the advisory agreement to the extent that these services were provided by Harris trading desk personnel. As described by McGregor, Fund portfolio managers sent trades to Harris trading desk personnel, these personnel exercised their discretion to place the order with

HASL, and then these personnel, essentially having placed the order with themselves, assumed their role as HASL broker in executing the trade. *See* McGregor at 204 ("the traders had to make the decision as to where the best execution could be achieved, and how they made that is something of their expertise, not mine"). The effect of this self-serving arrangement was to enable Harris to charge a commission in addition to the fees it already received under the advisory contracts for trading services. Conversely, if the same trading desk personnel had not allocated the trade to themselves (*i.e.*, as HASL brokers), but to an outside broker, then Harris would not have received the commission, and the Harris trading desk personnel would actually have provided the services that they were being compensated to provide.

36. In my opinion, HASL received commissions for order placement services that Harris was obligated to provide and pay for under paragraphs two and four of the Funds' advisory agreements. The payments to HASL therefore violated the advisory agreements, and Harris thereby violated its Section 36(b) fiduciary duty with respect to these payments.

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III. *Gartenberg* Standard

A. Advisory Fees

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6. Independent Directors' Independence, Care and Conscientiousness

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b. Independent Directors' Care and Conscientiousness

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v. Profitability

167. The independent directors were unable to evaluate the profitability of the Funds to Harris because the information that Harris provided regarding the Funds' profitability was materially misleading and substantially misstated Harris's actual profitability. A profitability analysis generally should calculate profits by deducting expenses from revenues to determine profit. Harris provided the independent directors with profitability charts that (1) treated profits as expenses, (2) impermissibly insinuated marketing expenses into the profitability analysis, (3) improperly allocated expenses by revenues, and (4) lacked any outside verification of the methodology or data used.

168. Harris presented a profitability analysis that grossly distorted its profitability in connection with the Funds. First, Harris include discretionary compensation as an expense, *see* Rotter at 155-56 (independent director considering all of discretionary compensation to be an expense), whereas the Record indicates that all or substantially all of discretionary compensation represented the distribution of profits to Harris partners. *See* HA 1842 (handwritten notes by Harris executive stating with respect to compensation pool that "Partners own this pool," "Pool ptrs comp goes up and down w/ revenues Inc perf" and "Benefits of ownership structure in current income stream"); *see also* Raitt at

228-36 (discussing same handwritten note); Neary at 12-13, 16 ("there is economic benefit to being a partner in the sense of the profitability of the firm you get to share in;" "kind of a typical profitability pool"); HA 2854-55 (in minutes Management Contracts Committee meeting, Raitt stating that discretionary compensation "consists of a 'profit pool' that is divided among partners and paid out annually" and that Harris's compensation "reflects the benefits of equity ownership"); Pomerantz Expert Report at 13. These profits should not have been treated as an expense. *See* Wilner at 228 (agreeing "to some degree" that discretionary compensation should not be included as en expense).

169. At least four independent directors understood that Harris partners received firm profits, yet still considered the relevant profit rate to be the one calculated net of discretionary compensation as if it were an expense. *See* Ruder at 145, 148; Hayden at 209-10, 229-30 (conceding that discretionary compensation included elements of a "true partnership" but considering it an expense); Friduss at 151-52 (discretionary compensation has "some semblance of ownership, kind of a partnership. So perhaps I would agree with Clyde that portion perhaps could be considered profit"); Morgenstern at 123, 136 (describing C pool, which is part of discretionary compensation, as a passive partnership interest; "whether a given individual received money because it was a share of profits or discretionary compensation or base salary or draw wasn't necessarily important to us"). Another director agreed that at least some of the discretionary

compensation reflected profits, but admitted that he had not taken such profits into account when evaluating Harris's profitability. *See* Wilner at 228, 233. This is inconsistent with any reasonable understanding of a profitability analysis, but he believed that removing the profit component would only be "an interesting intellectual procedure" because what matters is "what's the marketplace for these people." Wilner at 235. This director fundamentally misunderstood that his role was not simply to defer to the marketplace and that an honest profitability is more than an "interesting intellectual procedure."

170. Some of the independent directors justified treating the discretionary compensation as an expense on the ground that the payments were necessary to be competitive, *see, e.g.*, Rotter at 154-55, Wilner 236-37, but they had no basis for comparing compensation paid to the Funds' portfolio managers to compensation paid to outside mutual fund portfolio managers. *See* Wilner at 237-38 (independent director had no knowledge of Harris portfolio manager compensation relative to the marketplace and did not know where to find that information); Hayden at 135-36 (independent director did not know portfolio manager compensation or whether they were paid more or less than other portfolio managers); Morgenstern at 161-68 (evaluating portfolio manager's compensation on the basis of anecdotal information about hedge fund managers' compensation and compensation to portfolio managers who owned their firm). One independent director stated that compensation

paid to Harris mutual fund portfolio managers was "in line with other complexes of similar size," but could cite only representations made by counsel in support of that statement. Rotter at 157-58; *see also* Ruder at 152-54 (independent directors concluded it would be impossible to get comparable portfolio manager compensation information and they have no way of knowing whether Harris portfolio managers are paid more or less than other portfolio managers). Yet that director could not recall the amount of compensation paid to any Harris portfolio managers. *See* Rotter at 156; *see also* Ruder at 149-51 (independent director did not know amount of portfolio manager compensation); Wilner at 201 (same). Counsel told the directors that they did not need information on portfolio managers' compensation, *see* Hayden at 132, although the directors justified treating discretionary compensation as an expense instead of profits on the ground that doing so was necessary to be competitive. Some of the directors relied on anecdotal information about compensation to portfolio managers for non-mutual fund investment pools, *see* Rotter at 150-51, notwithstanding that surveys of actual mutual fund portfolio manager compensation were available. *See* Pomerantz Expert Report at 13 (Harris portfolio managers earned substantially more than other portfolio managers). When the independent directors requested portfolio manager compensation information from Harris, *see* HA 2848 (minutes of April 16, 2003, Management Contracts Committee meeting stating that directors requested "competitive compensation information to the extent available, that the adviser believes is

comparable and relevant to the Adviser's ability to retain talent."); HA 2841 (same in minutes of April 16, 2003, board meeting); *but see* Ruder at 148-50, Harris did not comply. Raitt explained Harris's noncompliance with the directors' request on the ground "that since the Adviser's compensation reflects the benefits of an equity ownership component, the Adviser was unable to find any meaningful comparative information to provide to the committee." HA 2855 (minutes of Management Contracts Committee meeting). Thus, on the one hand Harris treated discretionary compensation was an expense because it was paid to compete with other firms, while on the other hand Harris stated that it could not find comparative compensation data because discretionary was not an expense but a form of "equity ownership."

* * * * *

175. Third, Harris's method of allocating expenses among the different funds was fatally flawed. Harris allocated expenses by revenues, which had the effect of artificially inflating the profitability of smaller funds and artificially reducing the profitability of larger funds. *See* HA 1838 (allocation of expenses by fund); Rowsell #1 at 209-10 (salaries and rent allocated among funds based on revenues); Pomerantz Expert Report at 14; McGladrey Expert Report at 5. This is a particularly egregious distortion in the context of a *Gartenberg* profitability analysis because the purpose of the cost allocation is to gauge whether Funds' fees are excessive, and using the amount of the Funds' fees to allocate costs is fundamentally misleading. Allocating costs

based on the fees charged is a circular analysis that effectively validates the amount of the fees by allowing the amount of the fees to dictate the allocation of costs incurred in connection with the fees. Harris's approach assumes that it must have incurred the highest costs in connection with the funds paying the highest fees. This approach is not only intuitively and analytically bankrupt, but fundamentally inconsistent with the premise that as assets rise, fixed costs decline as a percentage of assets. This allocation methodology served Harris' purposes by concealing the excessive profitability of its larger funds, especially the Oakmark Fund and the Equity & Income Fund.

176. Fourth, the independent directors failed to take any steps to investigate these flaws or the facially deficient profitability analysis with which they were provided. Harris's profitability data were obviously distorted, yet the independent directors took no steps to obtain an objective evaluation of Harris's profits from the Funds. *See* HA 5317 (decision by Management Contracts Committee not to obtain objective evaluation of profitability analysis, apparently because it "would not be meaningful or cost-effective to do"); Rowsell #1 at 141; *see also* HA 133060 (portion of May 1, 2002, Management Contracts Committee meeting minutes deleting, with respect to seeking an objective review of the profitability analysis, the following statement: "Mr. Morgenstern stated that it might be advisable to ask Morningstar and Lipper whether they could provide such" analysis). Recognizing the falsity of Harris's data required no special

expertise or further investigation – the data on the charts were false on their face. For example, the Harris's 2001 profitability analysis showed revenues for the Select Fund and Global Fund as $34.1 million and $0.5 million, respectively, yet the pre-marketing profit margin for each was 48%[22] and 45%[23] respectively. These data – showing equivalent profitability for one fund with 65 times the revenues of the other, with only $0.523 in revenues – are facially implausible and reflect a gross distortion of Harris's profitability accomplished through a methodology that shifted expenses from small funds to large funds in order to reduce the reported profit rates for the larger funds. Further, the fund-by-fund tables show identical profit rates of 52.7%, a coincidence that belies the independent directors' blind reliance on these data. *See* HA 1836 (2002 profitability analysis showing profit rate of 52.7% for Oakmark, Select, Small Cap, and Equity and Income Funds); *see also* HA 459 (2003 profitability analysis showing profit rate of 54.5% for Oakmark, Select, Small Cap, and Equity and Income Funds); *see also* Wilner at 245 (conceding that profit rates in same range for different funds might result from allocation methodology).

177. Plaintiffs' expert accountants generally concurred in the foregoing, and added that the profitability analysis lacked adequate documentation, the expense allocation methodology was

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[22] Pre-marketing expenses of $16.387 million divided by revenues of $34.105 million equals 48%.

[23] Pre-marketing expenses of $0.234 million divided by revenues of $0.523 million equals 45%.

not reviewed by internal or external auditors, and the reporting system used by Harris prevented the determination of break-even points, economies of scale, and life-cycle costing. *See* McGladrey Expert Report at 5.

* * * * *

Respectfully submitted,

/s/ MERCER BULLARD

EXHIBIT A-4

Expert Report of James Lamb

* * * * *

RSM McGladrey
Assessment of Management Reporting and Calculation of Damages

Matter of Jerry N. Jones, Frances Jones and Arline Winnerman, Plaintiffs

vs.

Harris Associates, L.P., Defendant

Case No. 1:04-CV-08305

Prepared by:
James D. Lamb
Managing Director, Consulting Services

January 30, 2006

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EXECUTIVE SUMMARY

Qualifications

I was retained to provide detailed analysis and expert opinions on the profitability and financial reporting of Harris Associates, L.P. (Harris), and the fee structure of the Oakmark complex of funds (Oakmark). The main focus of my analysis was on the Oakmark Fund, the Oakmark Equity and Income Fund and the Oakmark Global Fund (the subject funds).

I am the Managing Director of Consulting Services for the RSM McGladrey Kansas City office. RSM McGladrey is a business services firm providing accounting, tax compliance and consulting services. RSM McGladrey is also the U.S. member of RSM International, the sixth-largest worldwide accounting and consulting organization, with more than 600 offices in 70 countries.

I, and others under my direct supervision, performed this analysis. I am qualified to provide an opinion in this matter based upon my education, training, knowledge, skills and experience. I am a Certified Management Accountant and have extensive with Cost Accounting methodologies and management reporting. My curriculum vitae is presented in the appendix, which summarizes my education and work history.

The purpose of this report is to present a summary of findings based on analysis performed on Harris and the Oakmark Funds. My report focuses on the assessment and analysis of management reporting to the Trustees of the Oakmark funds along with the

economic damages to the shareholders of these funds. This analysis largely focuses on the three subject Oakmark funds, but refers to other funds managed by Harris.

Analysis

To prepare this report, I performed three major assessments:

1. Cost Accounting Methodology Review
2. Advisory Fee Comparison including:
    - Institutional Account Fees
    - Sub-Advisory Fees
    - "Rack Rate" Fees
    - Fee Breakpoints
3. Damages Assessment

I have reviewed a number of depositions, deposition exhibits, documents received from Harris and industry related information. During my review, I identified a number of deficiencies for management reporting from which I conclude that the Trustees of the subject funds could not reasonably rely upon certain information provided to them, which is discussed further in this report. Additionally, my assessment of fees concluded that the advisory fees of the subject funds were in excess of, and inconsistent with, the pricing practices used with other Harris clients. Based upon my review of the information, there is no reasonable basis for the higher advisory fees charged to the subject funds, and in fact, due to the size of these funds, it can be reasonably expected that the advisory fees would be lower. I, therefore, conclude that the advisory fees charged to shareholders of the subject funds were excessive. The excessive advisory

fees are the basis for the damages suffered by the shareholders of the subject funds. The range of damages is based on comparing the subject funds' advisory fee schedules to schedules offered to Harris' other clients. The following sections summarize my findings for each of the above items.

Cost Accounting Methodology Review

- Harris did not provide credible profitability information that the Trustees of the subject funds could rely upon based on the following factors:
  - The Cost Allocation model utilized by Harris for the Oakmark funds is a simple form of cost accounting that has multiple flaws associated with management and financial reporting.
  - The allocation of expenses based on product revenues distorts the allocation of expenses to the largest funds.
  - There is a lack of adequate documentation of the cost accounting system, its allocation methodologies and the procedures for producing cost accounting reports. Additionally, there has been no documentation of the allocation model given to the fund trustees.[1]
  - There has been no review of the allocation model by internal or external auditors.[2]
  - The lack of procedural documentation and the absence of audit or review of the allocation model are examples of poor cost accounting and management accounting practices.

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[1] Deposition of Kristi Rowsell, June 15, 2005, page 141

[2] Deposition of Kristi Rowsell, June 15, 2005, page 140

- The management reporting system developed by Harris is unable to answer business questions regarding break-even point, economies of scale, life cycle costing and other pertinent business concerns, which prevents the Board of Trustees from developing any meaningful insights into the profitability of the subject funds.

- The most significant reporting flaws within Harris' profitability reporting include:
  - The accuracy of costs for each fund is highly distorted.
  - Harris allocates the partners' discretionary compensation (which is the remainder of the revenues after fund expenses have been paid)[3] as an expense to the funds. This is inappropriate and significantly decreases the perceived profitability of the subject funds.
  - The financial reporting package does not provide operational insights into fund operational costs.
- The Trustees were not provided adequate information from which informed negotiations and decisions could be made.

Advisory Fee Comparison

- Advisory fees for institutional accounts and subadvisory clients are negotiated by Harris as arms-

[3] Deposition of Kristi Rowsell, June 15, 2005, pages 186 and 187

length transactions by informed parties and as such represent market-based pricing.[4]

- At Harris, the subject funds pay advisory fees that are nearly twice as high or higher than fees paid by institutional accounts and sub-advisory clients pursuant to comparable arrangements even though the asset levels for the subject funds are significantly higher than the assets governed by those respective comparable arrangements.
- If Harris had charged the subject funds based on advisory fee schedules offered to institutional and sub-advisory clients, the subject funds would have saved between $36.8 million and $58.3 million in advisory fees during the damages period.
- Breakpoint schedules for Harris' institutional accounts and sub-advisory clients reflect market-based advisory service's pricing developed by negotiations conducted as arms-length transactions by informed parties.[5]
- Breakpoints in advisory fees come at much lower asset levels for institutional accounts and sub-advisory clients than they do for the mutual funds, thus providing higher discounts to these clients regardless of the initial fee charged.[6]
- Breakpoint discounts for advisory fees offer institutional accounts and sub-advisory clients sub-

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[4] See Institutional Client Contracts. For example HA 0134367, HA 0134383

[5] See Institutional Client Contracts. For example HA 0134367, HA 0134383

[6] For instance, in the published institutional fee schedules, the first breakpoint is reached at $50 million. For the mutual funds, the first breakpoint is not reached until $2 billion.

stantial savings while offering shareholders of the subject funds very little or no savings by comparison.

- The small breakpoints for advisory fees for the subject funds bear no relationship with market conditions (as seen in institutional and sub-advisory contracts), costs consumed or economies of scale realized by Harris.

Damages Assessment

Based on my evaluation of advisory fees charged to shareholders of the subject funds, I have calculated the economic damages based on a comparison of these fees to similar fees charged to Harris' other clients. The damages period is assumed to be August 17, 2003 through August 16, 2004. In addition, I have calculated damages for the period August 17, 2004 through the date of this report. These economic damages calculations will be updated to the date of trial using the same methodology set forth in this report. Additionally, I have documented damages based on disgorgement of the total advisory fees charged during the damages period.

Damages Based on Comparable Advisory Fee Arrangements

I have compared the advisory fees Harris charges the subject funds to the advisory fees Harris would have received had it charged the same fees as it charges pursuant to comparable arrangements. I have calculated damages as the difference between the fees paid by the subject funds and the fees Harris would have received pursuant to these comparable arrangements. The comparable arrangements are:

- Advisory fees Harris charges to its institutional accounts.
- Advisory fees Harris charges to its sub-advisory clients
- Rack rate advisory fees Harris offers for separate accounts

The following tables summarize the above comparison methods. For the damages period, the range in economic damages from the various approaches is $36.8 million to $58.3 million.

Assessment of Management Reporting and Calculation of Damages
Report as of January 30, 2006

Fund	Institutional Comparison	Sub-Advisory Comparison	Rack Rate Comparison	Damages Range Based on All Comparisons	
Oakmark Fund					
Damages Period (August 17, 2003 - August 16, 2004)	$29,212,399	$28,082,399	$20,454,119	$20,454,113	$29,212,399
End of Damages Period through Report Date (August 17, 2004 - January 30, 2005)	$47,184,062	$48,984,312	$33,874,445	$33,874,445	$47,184,062
Total Fund	$75,396,461	$75,036,711	$54,128,564	$54,128,564	$75,396,461
Oakmark Equity and Income Fund					
Damages Period	$25,920,367	n/a	$12,908,592	$12,908,592	$25,920,367
End of Damages Period through Report Date	$57,256,848	n/a	$27,381,855	$27,381,855	$57,256,848
Total Fund	$83,347,205	n/a	$40,290,447	$40,290,447	$83,347,205
Oakmark Global Fund					
Damages Period	$4,056,664	$3,395,331	$4,056,664	$3,395,331	$4,056,664
End of Damages Period through Report Date	$10,557,693	$8,665,905	$10,557,693	$8,665,905	$10,557,693
Total Fund	$14,614,358	$12,061,236	$14,614,358	$12,061,236	$14,614,358
Total Subject Funds					
Damages Period				$38,758,843	$58,259,429
End of Damages Period through Report Date				$69,722,395	$114,998,604
Total - Combined Period				$108,480,348	$173,258,034

Notes:
(1) Sub-advised account comparisons from Harris comparative fee schedule presented to the Board of Trustees (HA 000043B)
(2) Institutional account comparisons from Harris comparative fee schedule presented to the Board of Trustees (HA 000043B)
(3) Rack rate fees taken from Harris Associates L.P. Part II, Form ADV 3/31/2004 (HA 013693T)
(4) Calculations are based on Average Assets Under Management from the following sources:
2003 - from Harris Associates, L.P. AUM Analysis, December 31, 2002 (HA_H0000003)
2004 - from average ending invested assets for years ended September 30, 2003 and 2004
2005 - from average ending invested assets for years ended September 30, 2004 and 2005
2006 - from ending invested assets for year ended September 30, 2005

Disgorgement of Advisory Fees

The following chart reflects total disgorgement of all advisory fees during the damages period and through the date of this report.

Total Fees Paid			
Fund	Damages Period (August 17, 2003 - August 16, 2004)	End of Damages Period Through Report Date (August 17, 2004 - January 30, 2006)	Total
Oakmark Fund	$49,304,636	$85,143,135	$134,447,772
Oakmark Equity and Income Fund	$44,530,759	$90,674,527	$135,204,786
Oakmark Global Fund	$11,214,298	$22,993,611	$34,207,909
Total	$105,049,203	$198,811,273	$303,860,476

Notes:

(1) Damages Period includes:

24.6% of results from April 1, 2003 through September 30, 2003

87.7% of results from fiscal year end September 30, 2004

(2) End of Damages Period through Report Date includes:

12.3% of results from fiscal year end September 30, 2004

100% of results from fiscal year ended September 30, 2005

33% of the results for fiscal year ended September 30, 2005 data, the date of the last published financial results

Opinion

The profitability information provided to the Trustees of the subject funds could not be reasonably relied upon. Damages to shareholders of the subject funds range from $36.8 million to $58.3 million. Additionally, damages based on disgorgement of advisory fees total $105 million. If the damages are extended to this report date, damages range from $106.5 million to $173.3 million, or $303.9 million in disgorgement of advisory fees.

Expanded data and analysis to support my opinions are included in the body of this report.

I reserve the right to update this report based on additional information presented to me. I reserve the right to create tables, graphs, and models to explain and emphasize key assumptions and conclusions to support this report. I also reserve the right to update

this report based on potential rebuttals from experts retained by Harris Associates, L.P.

Sincerely,

/s/ JAMES D. LAMB

James D. Lamb
Managing Director
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COST ACCOUNTING METHODOLOGY REVIEW AND OTHER ACCOUNTING ISSUES

Summary Findings – Cost Allocation and Management Accounting

- Harris did not provide credible profitability information that the Trustees of the subject funds could rely upon based on the following factors:
  - The Cost Allocation model utilized by Harris for the Oakmark funds is a simple form of cost accounting that has multiple flaws associated with management and financial reporting.
  - The allocation of expenses based on product revenues distorts the allocation of expenses to the largest funds.
  - There is a lack of adequate documentation of the cost accounting system, its allocation methodologies and the procedures for producing cost accounting reports. Additionally, there has been no documentation of the allocation model given to the fund trustees.[7]
  - There has been no review of the allocation model by internal or external auditors.[8]
  - The lack of procedural documentation and the absence of audit or review of the allocation model are examples of poor cost accounting and management accounting practices.
  - The management reporting system developed by Harris is unable to answer business questions regarding break-even point, economies of

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[7] Deposition of Kristi Rowsell, June 15, 2005, page 141

[8] Deposition of Kristi Rowsell, June 15, 2005, page 140

scale, life cycle costing and other pertinent business concerns, which prevents the Board of Trustees from developing any meaningful insights into the profitability of the subject funds.

- The most significant reporting flaws within Harris' profitability reporting include:
  - The accuracy of costs for each fund is highly distorted.
  - Harris allocates the partners' discretionary compensation (which is the remainder of the revenues after fund expenses have been paid)[9] as an expense to the funds. This is inappropriate and significantly decreases the perceived profitability of the subject funds.
  - The financial reporting package does not provide operational insights into fund operational costs
- The Trustees were not provided adequate information from which informed negotiations and decisions could be made.

Background – Management Accounting

Management Accounting is a specialized field of analysis related to financial and statistical information. The premise with Management Accounting is to organize and report on various issues and topics to assist with managing the business. There are a variety of technical approaches used to represent findings and insights into these business issues and topics. Outlined below are examples of business top-

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[9] Deposition of Kristi Rowsell, June 15, 2005, pages 186 and 187

ics and best practices from Management Accounting that are the standards for this field of analysis.

Business Topic or Issue	Management Accounting Approach	Keys to Success
Capital Investment	Analysis based on incremental costs and incremental revenues.	Making sure that the model does not include existing direct and overhead costs.
Break-even Point for Profitability	Analysis based on fixed and variable costs along with marginal profit.	Defining fixed costs that are scalable for a number of units.
Economies of Scale	Analysis based on fixed and variable costs.	Defining fixed costs that are scalable for a number of units.
Developing products to a specific cost point	Target Costing analyzes current costs compared to targeted costs for components of producing a product or service.	Reasonably defining all costs and alternatives to obtain desired product profitability.
Determine ROI of Products	Life-Cycle Costing tracks direct and indirect product costs over the life of the product or service.	Tracking the fluctuations of costs over time.
Managing Supply Chain Costs	Value Chain Costing is based on cost information to include suppliers and distributors.	Reasonably understanding direct and indirect costs and inefficiencies from upstream and downstream suppliers.
Product Profitability	Analysis using Activity-Based Costing, where consumption of various activities creates cost.	Ensuring that only appropriate costs are assigned to activities and cost objects.
Maximize Efficiency and Throughput	Theory of Constraints analyzes the role of throughput, operational expense, and inventory.	Identifying and prioritizing constraints, and exploit the most critical constraint.

This orientation to Management Accounting is to lay the groundwork regarding Harris' approach to management accounting.

Cost Allocation Methodology Synopsis

The Cost Allocation methodology, utilized by Harris, is one of the most simplistic[10] and flawed methods of cost accounting for production and fund profitability reporting. It can grossly distort the indirect expense and overhead allocation by over-costing high volume products and under-costing low volume products.[11]

The graph below illustrates how simple overhead allocation can proportionately distort the profitability of a product, or in Harris' case, a fund. The higher volume products are assigned a disproportionate amount of the indirect expenses and overhead costs while the lower volume products have fewer expenses allocated to them. On both sides of the equation, the reasonable profitability of the product or service is distorted by the use of overhead allocations in lieu of an Activity-Based Costing approach.

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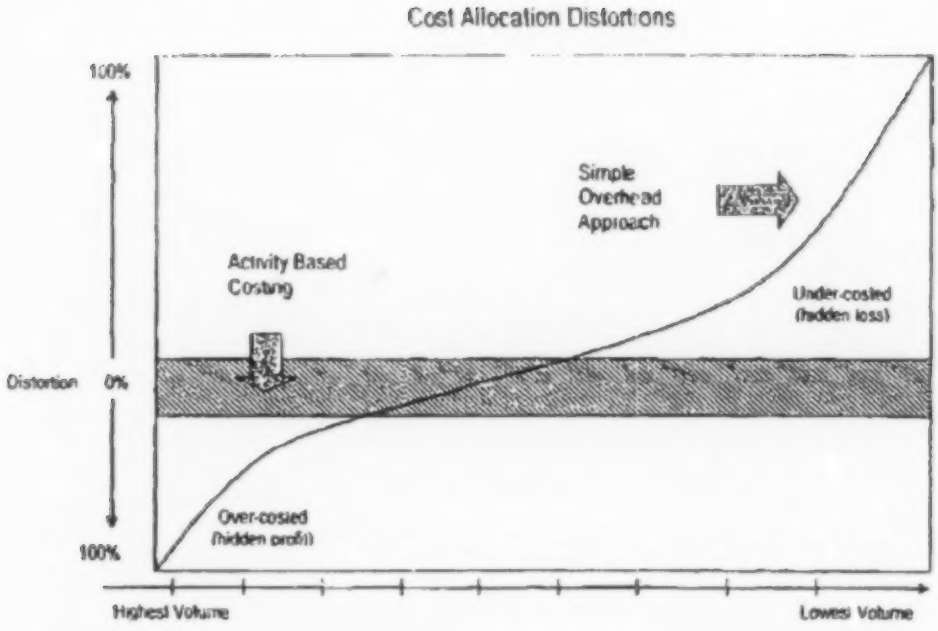
[10] In the Harris Terms Sheet (for example HA_S000008573), Harris acknowledges that their cost accounting methodologies are simple.

[11] Activity-Based Cost Management – An Executive's Guide; Gary Cokins; Page 13



A sophisticated Activity-Based Cost model provides product profitability that is more accurate and informative than the Simple Cost Allocation method.[12]

As costing models get more sophisticated and incorporate activity based accounting cost pools and multiple allocators, the cost information becomes more useful in terms of accuracy and utility for management decisions. The graph illustrates that simple allocation models can lead to highly distorted or inappropriate costs.

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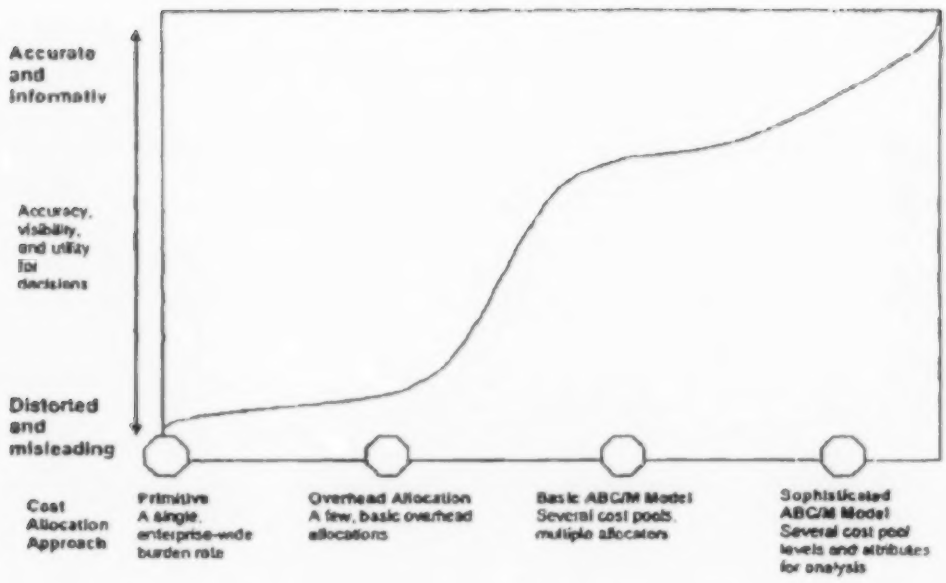
[12] Activity-Based Cost Management – An Executive's Guide; Gary Cokins; Page 57



Harris Cost Allocation Methodology

Harris uses a simple Cost Allocation methodology to assign shared expenses to the funds in order to calculate fund profitability. The first major step is to allocate general ledger costs to Lines of Business. The three lines of business are (1) Investment Advisory (which includes domestic institutional and domestic separate accounts), (2) Domestic Mutual Funds (which includes the domestic Oakmark funds and domestic sub-advised mutual funds), and (3) International Group (which includes the international Oakmark funds and international sub-advised funds as well as international institutional and separate accounts).[13] The allocations to the Lines of Business are listed on the Term Sheet and are primarily based on three differ-

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[13] Harris Associates L.P. Business Segment Revenue and Expense Determinations Terms Sheet, 2001 to 2003 (HA 0143960). Prior to 2003, Harris had four lines of business, including Alternatives (hedge funds) in addition to its three current lines of business.

ent ratios: headcount, assets and fund revenues. The remainder of the expenses are specifically allocated based on details in the Terms Sheet.[14] Even though Harris stated that they felt the simple allocation was sensible,[15] these methodologies do not yield reasonable profitability margins. It should be noted these terms sheets are not shared with the Board.[16]

The next step is to allocate Lines of Business costs to funds. The allocation of expenses to the individual funds is based on one of two allocation ratios: Percent of Revenue of the Line of Business (including institutional, sub-advised, and or separate accounts, when applicable), and Percent of Revenues of the Oakmark funds. Because all pre-marketing expenses are allocated by the percent of revenue each fund generates within its line of business, the pre-marketing profit ratios are identical for all funds within a business line.[17]

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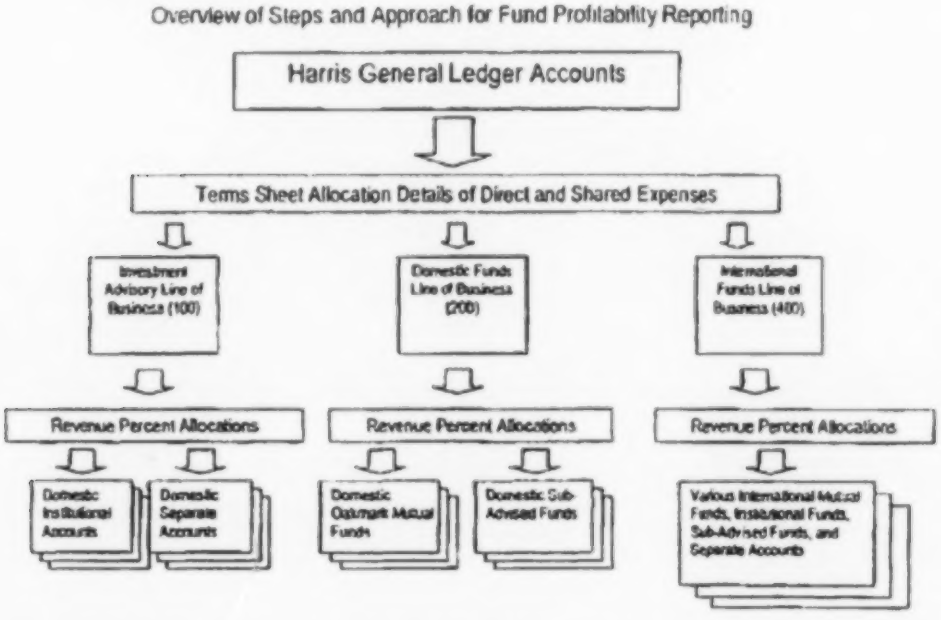
[14] Harris Associates L.P. Business Segment Revenue and Expense Determinations Terms Sheet, 2001 to 2003 (HA 0143957, HA 0143960, HA_S000008573)

[15] Ibid (stating that "Simple methodologies are not only sensible; they are also generally accurate.")

[16] Deposition of Kristi Rowsell, June 15, 2005, page 140

[17] The domestic Oakmark funds, which include the Oakmark Fund, the Oakmark Select Fund and the Oakmark Equity and Income Fund, have the same pre-marketing profitability margin each year, and the International Oakmark funds, which include the Oakmark International Fund and the Oakmark Small Cap International Fund, have the same pre-marketing profitability margin each year. The Oakmark Global Fund, which has assets in both the "Domestic Mutual Funds" lines of business and the "International Group" line of business, has a pre-marketing profitability margin each year that is a blend of the domestic and international margins. See, e.g., Harris Associates Invest-

The following is a general illustration of Harris' cost allocation model:



Harris' allocation methodology does not reasonably portray the consumption of shared expenses associated with each fund. In Harris' model, compensation, by far the largest expense for the mutual funds, is primarily a shared expense that is allocated to each fund based on the percent of revenues the fund generates. If one fund requires significantly more resources to manage the money (i.e., a new fund or an underperforming fund), these additional costs are not reflected in the expenses allocated to this fund. Those expenses are shared across all funds, which inherently distorts the reasonableness of the fund profitability model.

Additionally, the marketing expenses, fulfillment expenses, and shareholder service expenses are allocated to the funds based on each fund's revenue as

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ment Trust Advisor's Profitability Analysis Year Ended December 31, 2003 (HA 0000459)

a percent of total mutual fund revenues (excluding revenues from sub-advisory, institutional and separate accounts). Again, this results in identical ratios being applied to these expense categories for each fund. The ratios used do not reasonably reflect the level of effort and consumption of costs of each of the funds. There are more appropriate modeling approaches to align costs with specific funds through Activity Based Costing (ABC) modeling that aligns costs consumed to respective funds.

Overweighing of Allocations to the Larger Oakmark Funds

In general, the simple overhead allocation approach highly distorts costs allocated to products and funds. Over the past 10 to 15 years, manufacturing companies have estimated that indirect overhead costs were applied at 400% to 1200% of direct costs. Allocating indirect, shared costs with a general ratio will not provide insights to how costs are actually consumed, whereas activity based costing identifies activities that the indirect, shared services expenses support. Examples include call center activities, marketing activities, management activities, facility related activities, and office support activities.

Frequently, products and funds with high volumes will have a disproportionately high allocation of indirect costs when a simple allocation assigns these costs. The same is true for mutual funds. The larger funds would report economies of scale if an activity based costing approach that is tuned with the understanding of fixed and variable costs is used. The smaller funds would be required to absorb a more accurate amount of indirect, shared costs using an activity based costing methodology.

Lack of Documentation of Methodology for the Cost Allocation Model and Lack of External Review

Documentation explaining the cost allocation model is insufficient. There is no documentation or instructions telling or showing how data from the period expenses (specifically, how accounts from the Harris General Ledger system) flow into the model. There are no documented methodologies or guidelines for new expenses to be entered into the model.

Conclusions and Opinions Regarding the Harris Cost Accounting Model

Product Line profitability is the primary objective for the Harris Cost Allocation model. The findings presented above are examples of poor cost and management accounting practices. Without an allocation methodology that reflects the reasonable consumption of costs, without documentation of costing and allocation assumptions and the absence of periodic model assessment or review, the cost system is wrought with risk and inherent deficiencies. The Board of Trustees could not adequately rely on the information provided by Harris.

All of the business topics and issues listed in the overview of management accounting approaches are pertinent to Harris and to the Board of Trustees of the various funds. Without further development and evolution of their costing model to support the various management accounting approaches (e.g. incremental costing, fixed v. variable costing, target costing, and/or life cycle costing), the Board of Trustees remains uninformed regarding important issues. For example, it is clear that as the funds grow in size, increased profitability due to Economies of Scale

exist.[18] As the funds grow, the cost per asset dollar managed declines. The declining cost per unit is achieved by fixed costs being applied to more units. Additionally, as processes become more efficient through the use of technology, better training, advanced call center tools and router capabilities, and investor training using on-line tools, the many variable costs per unit have also declined. However, Kristi Rowsell stated that no one at Harris performed any analysis on economies of scale.[19] Inappropriate allocations and other poor management accounting practices render the Board of Trustees unable to develop any meaningful insights into the profitability of the subject funds and the extent of economies of scale enjoyed by Harris.

Additionally, over the past decade, there has been an ever increasing focus on insightful corporate reporting for Board Directors and shareholders. The result of that focus was the passage of the Sarbanes-Oxley

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[18] Between 12/31/2000 and 12/31/2003, assets under management for the Domestic Mutual Funds line of business increased from $4.7 billion to over $18.9 billion. During 2002 and 2003, as shown below, profits to the partners as reflected in the discretionary bonus pools paid to active and retired partners increase from $13.3 million to $65 million. As discussed below, most of these pools are profits, indicating to me that Economies of Scale as a result of increased fund assets were mainly being retained by the Harris partners. As discussed later in this report, the sharing of economies of scale with shareholders comes in the form of fee breakpoints. For the Oakmark Fund, these breakpoint discounts went from $1.8 million in 2000 to $4 million in 2003. Oakmark Equity and Income and Oakmark Global Funds received no breakpoint discounts during this time period. Additionally, the number of partners receiving D pool compensation decreased from 10 partners in 2000 to 9 partners in 2003. (HA_N000000041)

[19] Deposition of Kristi Rowsell, June 15, 2005, page 238

Act. Because of the Sarbanes-Oxley Act, corporations are held more accountable today than ever before to provide accurate information concerning their fiscal status, from which interested parties can make informed decisions. Harris has a fiduciary responsibility to provide the Boards with information from which the Board can make informed decisions. The information I have analyzed in this report is so distorted that it is unreasonable to expect the Board to be able to make informed decisions and negotiations concerning the management expenses of the mutual funds.

Harris Compensation

Compensation for Harris personnel who service the Oakmark funds is a significant expense.[20] Harris incurs compensation expenses in two ways. The first consists of the normal salaries and benefits that are paid to all employees. The second consists of bonus and discretionary compensation. Bonus and discretionary compensation are paid in three ways: through a firmwide bonus pool,[21] a discretionary bonus pool,[22] and the partners' compensation pools. The firmwide bonus pool and discretionary bonus pool are included

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[20] In 2003, Total Compensation expenses amounted to 44% of total mutual fund revenues; Harris Associates Investment Trust Adviser's Profitability Analysis Year Ended December 31, 2003 (HA 0000459)

[21] The firmwide bonus pool is a budgeted bonus pool that has ranged between 10% and 15% over the last five years. Participants in the firmwide pool are all employees with the exception of key professional management staff. Deposition of Kristi Rowsell, June 15, 2005, pages 70 and 71

[22] The discretionary bonus pool is a performance based bonus pool for key staff members such as investment, marketing, legal and operational professionals. Approximately 35 of the 160 Harris employees are compensated under this plan.

in the "Compensation" expense line item for profitability reporting.[23] The partners' compensation pools, which make up the "Discretionary Compensation" expense line item for profitability reporting, are the focus of this section.

There are currently 17 partners at Harris. The partners' compensation pools consist of payments made pursuant to the "C Plan" (sometimes called the deferred compensation plan) and the "D Plan." The purpose of the C Plan is to provide bonus compensation to certain key employees of Harris and to provide deferred compensation for certain key employees and former key employees.[24] Although the dollars that go into the plan are calculated based on a formula, the amount funded into the plan works out to

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[23] The notes from the board profitability reports seem to indicate that the discretionary bonus pool might be included in the "Discretionary Compensation" line item (e.g. HA 0000462), and Kristi Rowsell, Harris' Chief Financial Officer, testified as such in her deposition. Deposition of Kristi Rowsell, June 15, 2005, page 127. However it is footnoted in the internal Harris reports that the discretionary bonus pool is included in the bonus line items of the expenses. See Harris Associates L.P. – Domestic, Financial Highlights, December 2003 (HA 0143185) and Harris Associates L.P., Actual v. Budget, Dec. 31, 2003 (HA 0143196). This line item, when added together with the other personnel expenses on the internal report, ties back to the compensation line item on the working copy of the profitability report that is used to support the Trustee's profitability report but is not presented to the Trustees. See Harris Associates Investment Trust Breakdown of Revenues by Fund, Dec. 31, 2003 (HA 0009808). Therefore, I feel comfortable that the compensation line item for profitability reporting purposes includes salaries and benefits as well as the firmwide and nonpartner discretionary bonus pools.

[24] Harris Associates L.P. "C" Compensation Plan Summary Plan Description as Amended and Restated; Effective July 1, 2003 (HA 0145456)

be approximately 10% of revenues each year.[25] The D Plan payments, which are much larger than the C Plan payments, are comprised of the remaining revenues of the company after revenues have been shared with CDC Ixis, the parent company, who receives approximately 41% of Harris' total revenues each year, after the C Plan is funded, and after all other expenses have been paid.[26]

I believe that the vast majority of the C and D pools really represent additional profits of Harris. Harris' compensation costs are included in the Compensation line item, which consists of salaries and benefits, the firmwide bonus pool, and the discretionary bonus pool. I believe this is significant because including the entire C and D pools as expenses when calculating the profitability of the funds decreases the perceived profitability and thus provides Harris added justification for the current excessive advisory fee structure. Therefore, most of the C and D pools should be excluded from the expenses in the profitability reporting as they do not represent a reasonable expense of Harris and instead represent profits paid to the partners.

I have restated Harris pre-marketing profitability by subtracting that portion of the C and D pool payments that represent profits from the expenses reported to the trustees, leaving only that portion which represents reasonable compensation for the services performed by the partners who participate in the pools. In order to determine what constitutes reasonable compensation for this purpose, I reviewed

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[25] Deposition of Kristi Rowsell, June 15, 2005, page 91

[26] Deposition of Kristi Rowsell, June 15, 2005, pages 98 and 99

the Association for Investment Management and Research (AIMR) 2001 Investment Management Compensation Study.[27] The median compensation at large asset management firms for persons in the same positions and with the same experience as the partners at Harris is $11.8 million.[28] Total compensation for Harris partners in 2003 was $75 million, or over six times higher than the AIMR figure.[29] For the Domestic Mutual Funds line of business, this equates to over $44 million in excess compensation. My approach and methodology for this comparison for both 2002 and 2003 is shown below.

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[27] Association for Investment Management and Research (AIMR) 2001 Investment Management Compensation Study, May 2001

[28] For purposes of comparing the partners to the appropriate AIMR position, I used the job descriptions found on the Harris Associates website (http://www.harrisassoc.com/snrinvpr.asp). Comparable compensation figures represent the replacement cost for the position. Harris partners Jacobs, Mangan, Neary and Studzinski were excluded from this analysis because they did not become partners until 2004.

[29] Harris partner W-2 Tax statements, 2002-2003 (HA 0141809 – HA 0141863).

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Partner	Position	Years Exp	AIMR comparable position	AIMR Large Median - US	2001 - W2 Compensation	2002 AIMR Large Median Diff	2003 W2 Compensation	2003 AIMR Large Median Diff
Berman	Portfolio Manager	25	PM Dom	$792,500	$1,503,989	$711,489	$1,824,489	$1,031,989
Berson	Inv Analyst	24	Analyst - Dom Eq	$330,000	$2,451,226	$2,121,226	$2,897,824	$2,567,824
Berscheel	Dir of Research	19	Dir of Research	$477,760	$5,334,252	$4,856,502	$6,015,661	$5,537,901
Grant	PM	14	PM Dom	$792,600	$4,605,821	$3,713,421	$4,997,732	$4,175,232
Jacobs	Inv Analyst	14	Analyst - Dom Eq	n/a	n/a	n/a	n/a	n/a
Levy	CIO	29	CIO	$1,800,000	$10,190,872	$8,290,872	$12,415,775	$10,515,775
Loeb	Portfolio Manager	17	PM Dom	$792,500	$4,691,651	$3,899,351	$5,134,192	$4,341,892
Morgan	Portfolio Manager	17	PM Dom	n/a	n/a	n/a	n/a	n/a
McGregor	Portfolio Manager	28	PM Dom	$792,500	$4,976,147	$4,183,647	$5,182,754	$4,390,254
Neary	Exec	13	COO	n/a	n/a	n/a	n/a	n/a
Nygren	Portfolio Manager	24	PM Dom	$792,500	$12,438,872	$11,645,372	$15,011,618	$14,219,118
Rait	CEO	26	CFO	$1,500,000	$6,246,614	$4,746,614	$6,821,895	$5,321,895
Studzinski	Portfolio Manager	20	PM Dom	n/a	n/a	n/a	n/a	n/a
Total - Domestic Partners				$8,979,269	$52,348,935	$44,078,685	$60,271,961	$52,101,711
Hamo	CIO	20	CIO	$1,900,000	$4,123,033	$2,223,033	$6,591,791	$4,691,791
Clark	Portfolio Manager	11	PM Global Equities	$700,000	$1,441,937	$741,937	$2,466,359	$1,766,359
Taylor	PM/Research Director	11	PM Global Equities	$700,000	$1,845,817	$345,817	$1,908,981	$1,208,981
Welsh	Research	19	Analyst - Global Equities	$480,000	$3,141,567	$2,661,567	$4,200,552	$3,720,552
Total - International Partners				$3,780,000	$9,752,354	$5,972,354	$15,167,683	$11,387,683
Total - All Partners				$11,959,269	$62,091,289	$50,051,039	$75,439,634	$63,489,374
Total C pool - Retired Partners					$19,936,972		$23,230,206	
Total Firm C & D pool - Active partners					$73,939,183		$99,879,930	
Difference - Total firm to AIMR Large Median					$60,987,911		$76,720,580	
Percent of total pools allocated to Domestic Fund Line of Business (LOB)					59%		48%	
Excess C/D pool allocated to Domestic Mutual Fund LOB					$36,809,204		$44,051,928	
Domestic LOB AAUM					$14,443,306,847		$18,967,637,679	
Excess compensation in basis points to Domestic Fund LOB					25 bps		24 bps	
Percent of total pools allocated to International Line of Business (LOB)					16%		23%	
Excess C/D pool allocated to International LOB					$5,416,333		$17,675,995	
International LOB AAUM					$4,018,148,331		$7,295,168,619	
Excess compensation in basis points to International LOB					21 bps		33 bps	

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Additionally, I analyzed the effect of removing the excess compensation, as compared to the AIMR Study, from the pre-marketing profitability that was reported to the Board of Trustees. The results are shown below:

	Restated Pre-Marketing Profit Margins			
	2002		2003	
Fund	**Profit**	**Profit Margin**	**Profit**	**Profit Margin**
Oakmark				
Reported	$19,534,543	52.7%	$22,046,001	54.5%
Restated	$31,280,360	84.3%	$34,939,870	86.4%
Difference	**$11,745,817**	**31.7%**	**$12,893,869**	**31.9%**
Equity/ Income				
Reported	$8,463,285	52.7%	$15,341,404	54.5%
Restated	$13,550,317	84.3%	$24,313,965	86.4%
Difference	**$5,087,032**	**31.6%**	**$8,972,561**	**31.9%**
Global				
Reported	$934,114	49.7%	$2,525,823	52.5%
Restated	$1,494,858	79.6%	$4,075,183	84.8%
Difference	**$560,744**	**29.9%**	**$1,549,360**	**32.2%**

ADVISORY FEE COMPARISON – INSTITUTIONAL AND SUB-ADVISORY ACCOUNTS

Summary Findings

- Advisory fees for institutional accounts and sub-advisory clients are negotiated by Harris as arms-length transactions by informed parties and as such represent market-based pricing.[1]
- At Harris, the subject funds pay advisory fees that are nearly twice as high or higher than fees paid by institutional accounts and sub-advisory clients pursuant to comparable arrangements even though the asset levels for the subject funds are significantly higher than the assets governed by those respective comparable arrangements.
- If Harris had charged the subject funds based on advisory fee schedules offered to institutional and sub-advisory clients, the subject funds would have saved between $36.8 million and $58.3 million in advisory fees during the damages period.

Background – Institutional and Sub-Advisory Services

Institutional accounts are accounts that are opened by a single institutional investor such as a pension plan, corporation or foundation. Harris provides investment management services to these institutional portfolios by offering the portfolio mix established in existing retail mutual funds.

Sub-advisory services are the outsourcing of the investment management of a mutual fund by an

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[1] See Institutional Client Contracts. For example HA 0134367, HA 0134383

advisor to a non-affiliated sub-advisor.[2] Responsibilities are generally limited to selecting and overseeing a portfolio of securities pursuant to a contract. Sub-advisors may furnish reports on investment results, but fees for other services are generally charged separately. Harris currently renders sub-advisory services to several clients and is active in pursuing these relationships as evidenced by its response to multiple questionnaires and requests for proposals (RFPs). The sub-advisory market is an extremely efficient market for fund advisory services. That is, before sub-advisory agreements are executed, the sub-advisor's investment performance is scrutinized by the potential fund advisor (the "buyer") to make sure that the fund's track record will be successful in attracting new assets.

Harris' institutional accounts and sub-advisory clients receive substantially the same investment advisory services that are provided to the Oakmark funds.[3] However, there is a significant difference in pricing for the Oakmark funds and the other accounts. For example, the Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund still pay advisory fees that are 145% to 291% of the fees paid by institutional accounts and sub-advisory clients,[4] as can be seen in the following chart.

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[2] Merrill Lynch: Sub-advisory, A flexible solution to the fund manufacturing challenge (#15672, June, 2004)

[3] Deposition of Henry Berghoef, August 30, 2005, pages 36 and 37. Deposition of William C. Nygren, November 17, 2005, page 47. Harris Associates Domestic Architecture (HA_S 000127577)

[4] Harris Board Report (HA 0000438); Harris Institutional Account Fee Summary (HA 0135013X); Strategy Codes, Codes for Fee Schedules (HA 0135013X, HA 0135028A, HA 0135008)

Fund	Sub-Advisory Account Comparable Advisory Fees	Institutional Account Comparable Advisory Fees	Mutual Fund Advisory Fees	Percentage Difference Mutual Fund Fees to Sub-Advisory Fees	Percentage Difference Mutual Fund Fees to Institutional Account Fees
Oakmark	$18,635,986	$18,485,986	$46,698,385	250.6%	252.6%
Oakmark Equity & Income	n/a	$13,631,765	$39,622,122	n/a	290.7%
Oakmark Global	$5,092,997	$4,431,664	$7,391,044	145.1%	166.8%

Background – Rack Rates

Advisors use Form ADV to register as an investment adviser with the SEC. Part I contains information about the adviser's education, business, and an advisor's disciplinary history within the last ten years. Part II includes information on an adviser's services, fees, and investment strategies.[5] Harris filed Form ADV, Part II on March 31, 2004.[6] This schedule contains the standard, "rack rate" fees that Harris offers for separate accounts before any negotiations. The form filed in March 2004 contains standard fee schedules for their account styles.

Comparative Styles

My selection of fund styles and comparative institutional and sub-advisory contracts was based on several criteria. For purposes of the damages calculation I have grouped the funds into investment style categories corresponding to institutional investment styles and fees reported in the Form ADV, Part II filed with the SEC ("rack" rates), and/or the styles and pricing reported to the Board.[7] The following sections set forth my rational for determining the comparison style for each fund. Additionally, I compared the institutional, sub-advisory and rack rate

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[5] SEC government website www.sec.gov

[6] Harris Associates L.P. Form ADV, Part II 3/31/2004 (HA 0136937)

[7] Harris Board Report (HA 0000438)

fee schedules for each applicable investment style to the subject fund, and using the average assets under management (AAUM) for each fund, applied the advisory fee schedule including any applicable breakpoints. I then compared the total advisory fees that the fund would have paid under the comparable fee schedule to the advisory fees that would be paid using the funds' actual fee schedule per the annual report.[8] The difference in those fee schedules over the course of the specified damages period[9] is shown in the conclusion of this section.

Oakmark Fund

For the sub-advisory comparison, I used the MetLife agreement which is the fund comparison utilized by Harris in its report to the Trustees and is found in the Harris Board Report.[10] For the institutional account comparison, I used Client #2 which is also the fund comparison utilized by Harris in its report to the Trustees and is found in the Harris Board Report.[11]

Oakmark Equity & Income Fund

For the institutional account comparison, I used the Client #1 agreement which is the fund comparison utilized by Harris in its report to the Trustees and is found in the Harris Board Report.[12] In that report, Harris classifies the Oakmark Equity and Income

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[8] Oakmark Audited Financial Reports for the years ending June 30, 2003, 2004 and 2005

[9] The damages period begins on August 15, 2003 and extends to August 16, 2004

[10] Harris Board Report (HA 0000438)

[11] Ibid

[12] Ibid

fund as a Balanced style fund. To my knowledge, Harris has not entered into an agreement to sub-advise a Balanced style portfolio; therefore a sub-advisory comparison is not applicable.

Oakmark Global Fund

For the sub-advisory comparison, I used the Asahi Global Fund agreement, which is the fund comparison utilized by Harris in its report to the Trustees and is found in the Harris Board Report.[13] For the institutional account comparison, I used Client #1, which is also the fund comparison utilized by Harris in its report to the Trustees and is found in the Harris Board Report.[14]

Conclusion

The financial damages calculated from these methods range from $36.8 million to $58.3 million during the damages period, August 17, 2003 to August 16, 2004.[15]

Fund	Institutional Comparison	Sub-Advisory Comparison	Rack Rate Comparison	Damages Range Based on All Comparisons	
Oakmark Fund					
Damages Period (August 17, 2003 - August 16, 2004)	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Oakmark Equity and Income Fund					
Damages Period	[illegible]	n/a	[illegible]	[illegible]	[illegible]
Oakmark Global Fund					
Damages Period	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Total Subject Funds					
Damages Period				[illegible]	[illegible]

Notes:
(1) Sub-advised account comparisons from Harris comparative fee schedule presented to the Board of Trustees (HA 0000439)
(2) Institutional account comparisons from Harris comparative fee schedule presented to the Board of Trustees (HA 0000438)
(3) Rack rate fees taken from Harris Associates L.P. Part II, Form ADV 3/31/2004 (HA 0136937)
(4) Calculations are based on Average Assets Under Management from the following sources:
2003 - from Harris Associates, L.P. AUM Analysis, December 31, 2003 (HA_M00000003)
2004 - from average ending invested assets for years ended September 30, 2003 and 2004
2005 - from average ending invested assets for years ended September 30, 2004 and 2005
2006 - from ending invested assets for year ended September 30, 2005

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[13] Ibid

[14] Ibid

[15] Utilizing these fees schedules for the subject funds for the year 2003 (latest available firmwide financial results) still produces a profit of approximately $30 million before the allocation of the C and D bonus pools.

ADVISORY FEE COMPARISON – FEE BREAKPOINTS

Summary Findings

- Breakpoint schedules for Harris' institutional accounts and sub-advisory clients reflect market-based advisory service's pricing developed by negotiations conducted as arms-length[16] transactions by informed parties.
- Breakpoints in advisory fees come at much lower asset levels for institutional accounts and sub-advisory clients than they do for the mutual funds, thus providing higher discounts to these clients regardless of the initial fee charged.[17]
- Breakpoint discounts for advisory fees offer institutional accounts and sub-advisory clients substantial savings while offering shareholders of the subject funds very little or no savings by comparison.
- The small breakpoints for advisory fees for the subject funds bear no relationship with market conditions (as seen in institutional and sub-advisory contracts), costs incurred, or economies of scale realized by Harris.

Breakpoints

Fee breakpoints are an arrangement that automatically reduces the management fee rate as the asset size of the individual fund or account increases.

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[16] See Institutional Client Contracts. For example HA 0134367, HA 0134383

[17] For instance, in the published institutional fee schedules, the first breakpoint is reached at $50 million. For the mutual funds, the first breakpoint is not reached until $2 billion.

Harris' operations for managing institutional accounts and sub-advising other mutual funds are almost purely for advisory services. I can, therefore, conclude that the breakpoints offered to Harris' institutional and sub-advisory clients compensate the clients for economies of scale largely in advisory portion of the service. I also conclude, based on the deposition of Harris' Director of Research, Henry Berghoef, that advisory services for institutional and mutual fund accounts are substantially the same.[18]

Because administrative services are paid separately, I also conclude that the shareholders of the Oakmark funds should be entitled to the same fee breakpoints for advisory services as the institutional and sub-advisory clients. The shareholders of the Oakmark funds should benefit from the same or similar breakpoints as Harris' other clients based on the economies of scale realized by Harris in providing advisory services.

Conclusion

Harris' institutional account clients receive discounts from breakpoints that are not given to the shareholders of the subject funds.

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[18] Deposition of Henry Berghoef, August 30, 2005, pages 36 and 37. Deposition of William C. Nygren, November 17, 2005, page 47. Harris Associates Domestic Architecture (HA_S 000127577)

Rebuttal Expert Report of James Lamb

* * * * *

RSM McGladrey

Rebuttal Expert Report

Matter of Jerry N. Jones, Frances Jones and Arline Winnerman, Plaintiffs

v.

Harris Associates L.P., Defendant

Case No. 1:04-CV-08305

Prepared by:
James D. Lamb
Managing Director, Consulting Services

August 10, 2006

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Cost Accounting Methodology

In Mr. Blake's review of HALP's managerial accounting system, he states the following:

- A complex managerial accounting and cost allocation system does not always provide more accurate information.[1]
- HALP's managerial accounting system was monitored, maintained and assessed on a consistent basis; performed financial analyses in a reasonable manner; fulfilled its intended purpose of producing decision making information; and was supported by reasonable assumptions and documentation which confirmed that the managerial accounting system worked in the manner intended.[2]
- The accounting treatment of the "C" and "D" plan compensation was appropriate.[3]

System Complexity Versus Accuracy and Purpose

Mr. Blake states a complex managerial accounting system does not always provide more accurate information. I disagree with that assumption. Even though a simple methodology may reasonably estimate the profitability for a product, only an activity-based methodology can accurately and reliably measure profitability information. Therefore, the intended purpose and audience of the reports must

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[1] Expert Report of Thomas M. Blake, Revised May 2, 2006, page 5

[2] Ibid. Page 6

[3] Ibid. Page 18

be taken into consideration when deciding upon the methodology to be used.

Generally, a company produces product profitability reports to assist internal management with business decisions. However, mutual fund advisors, like Harris, are required to provide their fund trustees with profitability reports so the trustees can assess the reasonableness of the advisory fees charged in relation to that profitability. Harris has a duty to assist the trustees in fulfilling that obligation by providing profitability reports that possess a higher level of accuracy than if the reports were viewed only by internal users.

Mr. Blake credits Harris with "employing significant effort" in formulating metrics applied to its managerial accounting system.[4] However most of its efforts are spent in assigning expenses to lines of business (LOB). There is no reasonable methodology for allocating the consumption of those LOB expenses into each of the mutual funds, which is done in a second allocation cycle. In this cycle, expenses are simply allocated to the mutual funds based on the fund's relative percentage of revenues.[5] The expenses allocated to the funds thus bear no reasonable relation to the actual consumption of costs.

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[4] Expert Report of Thomas M. Blake, Revised May 2, 2006, page 6

[5] Expenses are allocated to the funds based on the funds relative percentage of Line of Business (LOB) or Mutual Fund Revenues with the exception of No Transaction Fee (NTF) expenses, which are tracked by fund. Harris Associates Investment Trust Breakdown of Revenues by Fund, Year ended December 31, 2003 (HA 0009808)

For example, HALP could greatly improve profitability reporting by simply allocating partner compensation to the appropriate funds. For the largest fund expenses, deferred and discretionary compensation of the partners, this information already exists in the memos portfolio managers produce yearly to the internal compensation committee.[6] Simply transferring this information into HALP's cost accounting system would produce far more accurate profitability statements. Additionally, as noted later in this report, a large portion of partner compensation is actually profit sharing.

Mr. Blake validated the soundness of Harris' cost accounting approach by using other "high level" metrics to make additional profitability estimates and compares the results to the results reported by Harris. However, his use of high level metrics is a poor substitute for specific allocations required for a human capital intensive business. Second, and more important, the high level metrics chosen were inappropriate and biased towards large, profitable funds, just as those chosen by Harris were.

Allocations based on assets, asset growth or revenues are inappropriate for the following reasons:

- Profitability results from such an allocation methodology do not accurately reflect the true cost of activities required to operate a mutual fund.

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[6] For example, HA0138948

- This methodology produces profit margins that are exactly the same, or are compressed into a narrow range, hiding economies of scale.[7]
- Large, established funds are portrayed as requiring proportionately more investment management costs than smaller, less mature funds.

In summary, there are cost accounting approaches that more appropriately assign costs to each mutual fund. Using the relative percentage of revenues for allocating expenses is a poor approach for mutual fund costing.

Methodology Review and System Maintenance

Blake also states there is no requirement for an independent review of cost accounting reports.[8] The lack of a legal requirement for a review and assessment of these reports does not override the need for one. External trustees rely on the cost accounting information to make decisions and negotiate management fees on behalf of many shareholders. Because there are no standards for cost accounting, misuse and errors can result. The financial impact of inappropriate allocations can be significant. For example, one of the duties of the fund trustees is to review fund profitability and cost information to determine to what extent economies of scale are being achieved by the advisor and shared with the investors. However, at Harris, because fund expenses are allocated by relative percentage of revenues (with the

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[7] See Adviser's Profitability Analysis, Year Ended December 31, 2003 (HA0000459). The pre-marketing profit margin for Oakmark, Select, Small Cap, and Equity and Income Funds are all 54.5%

[8] Expert Report of Thomas M. Blake, Revised May 2, 2006, page 17

exception of the no transaction fee (NTF) expenses),[9] economies of scale, as evidenced through profit margins that increase as a function of assets under management, are virtually hidden from the fund trustees.[10] For this reason, a review or assessment by an outside party is very important. In fulfilling their obligation, independent, external trustees should insist upon and be provided with an external validation of reports they are relying on. A good business management practice would imply the need for a periodic review by an objective expert regarding the appropriateness of Harris' cost accounting approach.

Compensation

Blake states in his report the employees referred to as partners are not really partners and their compensation is reflected as an expense to the company in their audited financial statements.[11]

While, as Blake points out, technically these persons are employees, HALP's methodology for compensating these employees is profit sharing and should be disclosed as such. These payments should be largely excluded from the profitability reporting as pre-

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[9] Expenses are allocated to the funds based on the funds relative percentage of Line of Business (LOB) or Mutual Fund Revenues with the exception of No Transaction Fee (NTF) expenses, which are tracked by fund. Harris Associates Investment Trust Breakdown of Revenues by Fund, Year ended December 31, 2003 (HA 0009808)

[10] See Adviser's Profitability Analysis, Year Ended December 31, 2003 (HA 0000459). The pre-marketing profit margins for Oakmark, Select, Small Cap, and Equity and Income Funds are all 54.5%

[11] Expert Report of Thomas M. Blake, Revised May 2, 2006, page 18

sented to the fund trustees. My reasoning for this opinion is as follows:

- Those employees referred to as partners by HALP[12] are paid a salary plus the remainder of revenues after all company expenses have been paid.[13] The remainder of revenues after expenses have been paid is by definition "profit". For Harris partners, the vast majority (94%) of their compensation comes from these profits.[14]
- In 2003, the 13 employees referred to as partners received, in aggregate, compensation of over $75 million (an average of over $5.7 million per partner), or six times the large company mutual fund compensation median according to the Association for Investment Management and Research (AIMR, now known as the CFA Institute).[15]

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[12] "Only unit holders of the C pool get compensation from the pool. The people who are unit holders are the people that have been designated as partners or the ones that we refer to as partners"; Deposition of Kristi Rowsell, June 15, 2005, page 90

[13] "Q. And then your operating expenses. And then whatever is left goes into this partner's pool, correct? A. That's correct"; Deposition of Kristi Rowsell, June 15, 2005, page 99. "Each year the partners of Harris Associates essentially divide up the profits of the firm after paying out: 1) a fixed share of revenue to our parent company and 2) deferred compensation payments (C Plan). (HA 0001830-HA 0001832)

[14] For example, in 2003, total partner compensation was $77.8 million. Of this amount, approximately $4.5 million (less than 6%) was paid as a salary

[15] Harris partners W-2 tax statements, 2002-2003, (HA0141809-HA0141863); Association for Investment Management and Research (AIMR) 2001 Investment Management Compensation Study, May 2001. See Exhibit 3 for a full analysis of the partner's compensation

- These (profit sharing) costs are not incurred from an activity such as managing money, but rather as a byproduct of increased revenues, and these costs represent a decision by the company on how to spend retained profits. A certain amount of the profits are used to fairly compensate the partners.[16]
- Audited financial statements have different rules and serve a different purpose from mutual fund profitability reporting. The goal of financial statement reporting is to give a proper picture of the financial condition of the company, whereas the goal of profitability is to give a reasonable and transparent picture of the profitability of a product. In the later case, cost accounting best practices dictate that non-operational expenses such as excessive profit sharing, investment gains or losses, charitable giving and restructuring expenses be excluded from profitability reporting since they are not incurred as a result of an activity required to produce a product or service.

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[16] "In the long run, the market adjusts our compensation. The firm's assets and a fund's assets move up and down with performance." Portfolio Manager/Analyst Compensation Process (HA 0001831)

Comparison of Investment Advisory Services and Comparable Fees

Mr. Blake also contends in his report:

- Services rendered to the subject funds are different than services rendered to HALP's institutional and sub-advisory clients.[17]
- Comparison of the fees charged to the Oakmark Funds with those of separate and sub-advised accounts is inappropriate and varies based on the particular comparable separate or sub-advised account that is chosen.

Investment Advisory Services

While there are differences in the non-investment advisory services, the investment advisory services provided to Harris' mutual fund, separate account and sub-advisory clients are substantially the same.[18] The results of my analysis show:

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[17] Expert Report of Thomas M. Blake, Revised May 2, 2006, page 15

[18] Deposition of William Nygren, November 17, 2005, page 43 "Q. And does he do research for both the mutual funds and the separate accounts that you have at Harris Associates? A. Yes, all of our analysts do research for all of our clients."; ibid, page 47, "Q. Is that an account that's run in a similar fashion to the Oakmark Select Fund? A. It's really run – similar is a touch word there. It's not – it's not run the same as Oakmark Select. All of our accounts are run in a similar fashion if you think about the investment philosophy that's behind them." Deposition of Henry Boerghoff, August 30, 2005, page 37 "Q. The work of all 16 of you goes to all the investment managers, including portfolio managers of the mutual funds, the private accounts, the institutional account, high net work, limited partnerships, et cetera? A. It goes to all people with investment decision-making responsibilities within the firm."; Preliminary Expert

- The fully allocated costs (including overhead) of the two departments Mr. Blake cites as largely dedicated to the mutual funds are 1.56 bps.
- Full time equivalents (FTEs) dedicated to the mutual funds only account for 28 percent of total FTEs, while mutual fund AAUM are 48 percent of total AAUM.
- The fully allocated cost (including overhead) of employees who spend a percentage of their time on the Oakmark Funds is less than for other products.

First, Mr. Blake never cites any differences in investment advisory services. Rather, he focuses on two differences in non-investment advisory services. Specifically, he states the Fund Operations department is a functional area in Harris that provides services only to the mutual funds and not to separate and sub-advised accounts.[19] Blake also states the HALP Fund Accounting department provides services to the mutual funds that are not provided to other clients. If I accept Mr. Blake's premise and the analysis used in his report and calculate the cost in basis points (bps) to the mutual funds, we quickly find a negligible impact. To do this, I performed a simple analysis by allocating 100% of the salaries and benefits of these two groups (fund accounting and fund operations, even though fund accounting is not devoted 100% to the mutual funds). Further,

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Report of Edward S. O'Neal, Jan. 30, 2006, at pp. 19-20; Expert Report of Steve Pomerantz, Jan. 30, 2006, at pp. 15-17

[19] Expert Report of Thomas M. Blake, Revised May 2, 2006, page 15

I allocated a respective portion of overhead costs[20] associated with these two department's 16 FTEs. This annual cost of $2.7 million (see Exhibit 1) is then converted to bps using total mutual fund AAUM of over $17.6 billion. This translates into 1.56 bps, a result that in no way justifies an advisory fee that is 40 to 65 basis points higher for the mutual funds.[21]

Second, Mr. Blake's analysis is fundamentally flawed in that, by focusing only on the specific departments mentioned above, he ignores the actual cost differential to Harris in providing services to the Oakmark Funds and Harris' other accounts. In order to examine this cost differential, I used Harris' own time estimates (the same estimates used by Mr. Blake for his analysis) to allocate the salaries and benefits (S&Bs) of all Harris employees and partners to the Oakmark funds as well as a respective portion of Harris' overhead costs.[22] With respect to the compensation of the Harris partners, I did two separate analyses. First, I substituted the AIMR median compensation for large investment companies for Harris' actual partner compensation. Second, I used Harris' actual partner compensation even though, as stated above, much of this compensation actually represents profits. In both cases, I allocated overhead costs based on the relative number of FTEs of the Oakmark Funds and Harris' other products.

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[20] Overhead, as used in this and the following analyses, includes all corporate expenses except salary and benefits and no transaction fee (NTF) expense

[21] See Exhibit 1 of this report

[22] Oakmark time estimates are from Mr. Blake's report, as revised May 2, 2006. His original source is HA 0009850

My analysis shows only 50 of 179 FTEs (28%) are dedicated to the Oakmark Funds. The remaining 129 FTEs (72% of all FTEs) are dedicated to products other than the Oakmark funds. This is contrary to Mr. Blake's notion that the funds require more services than the separate and sub-advised products since almost half of Harris' assets under management are in the Oakmark Funds, yet only 28% of the FTEs are devoted to the Oakmark Funds.[23] Furthermore, my analysis shows the cost of providing services to Harris' separate and sub-advised products is actually 2.8 to 6.6 bps higher than the cost of providing services to the Oakmark Funds, depending on whether I use the AIMR median compensation or Harris' actual partner compensation.

	Expenses allocated using AIMR median comp for partners and O/H allocated based on relative % of FTE	Expenses allocated using Harris actual allocation estimates and O/H allocated based on relative % of FTE
Oakmark Funds costs in bps	9.9	29.9
Other products costs in bps	16.5	32.7
Difference	(6.6)	(2.8)

Advisory Fee Comparison

Mr. Blake claims the amount of excessive fees varies depending on which separate account or sub-advised contract is used as comparison. However, Mr. Blake failed to understand an approach that uses both the lowest rates offered and Harris' "rack rates", that is, the standard rates published in SEC form ADV, can

[23] See HAN_000003.xls. Mutual fund AAUM for 2003 were $17.6 billion (or 48% of Harris $36.5 billion in AAUM)

be used to illustrate the range of excessive fees. The lowest advisory fee results in a fee differential for one end of the excess fee range and indicates the negotiated rate that the advisor is willing to accept for the service. This range is intended to allow for differences in account size and service offerings, as larger accounts may be offered lower fees. Additionally, the lower rates illustrate the effect that arms-length negotiating may have on fees.

* * * * *

Exhibit 1

Fund Accounting (100% of S&Bs)			Overhead	
Adame	383,735		Marketing materials	3851,543
Corbin	77,338		Marketing Promotions	318,388
Ellis	85,539		Fulfillment & shareholder svc	370,426
Kane	170,974		Mktg rep - other	2,510,930
Leclair	85,269		Research & data svcs	845,657
Modica	85,269		Communication svcs	159,824
Northrop	77,466		License fees	196,564
Orvick	41,773		Rent	932 908
Rapoport	74,380		Maintenance	32,609
Subtotal	$780,793		Telephone	283,089
			Insurance	787,121
			Depreciation	937,731
Fund Operations (100% of S&Bs)			Business resumption	137,248
Brennan	$79,555		Furniture	78,827
Dimmick	81,683		Computer	154,750
Regan	789,557		Postage	99,116
Steward	70,979		Supplies	320,091
Symington	88,840		Consumables	183,217
Watson	91,304		Subscriptions	133,234
Wright	183,391		Associations	80 440
Subtotal	$875,258		Legal and audit	817,542
			Errors expense	168,546
Total Fund Acctg & Ops	$1,656,052		Other	173,944
			Use and Other Tax	33,181
Fund Acctg & Ops headcount	10		Restructuring	196,047
			Travel	906 012
			Consulting	635 358
			Charitable contributions	140,644
100% of Fund Acctg & Ops S&Bs	$1,656,052		Total Overhead	$12,289,948
Overhead applied to Fund Acct & Ops based on headcount	$1,099,543			
Total Fund Acctg & Ops cost	$2,754,395		Total Harris headcount	178
			Overhead / headcount	568 659
Mutual Fund AAUM	$17,530,746,462			
Fund Acctg/Ops in bps	1 95			

Source
Expenses December 31, 2003 Total Firm VS (HA_0009830)
Salaries - Blake report - Exhibit 1 (HA_N000003331)
AAUM - Harris Associates AAUM (HAN_000003)

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EXHIBIT A-5

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

PRELIMINARY EXPERT REPORT[1]
EDWARD S. O'NEAL, PH. D.

I have been engaged by the counsel to the plaintiffs to provide analysis and opinion and, if necessary, to give expert testimony on several issues involved in this case. These issues all relate to economies of scale in fund costs and fees in the management of mutual funds.[2] I am compensated for my work at a rate of $350 per hour plus out-of-pocket expenses. My compensation is in no way contingent upon my

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[1] Analysis of these issues in ongoing. The observations, analysis and conclusions of this report may change as additional data is made available and analyzed. In addition, I reserve the right to prepare charts and graphs as demonstrative exhibits using the data relied upon in the preparation of this report. I also may prepare analyses in response to defendant expert reports.

[2] My resume is attached as Exhibit A.

opinions or the testimony I intend to offer in this case.

Economies of Scale

Economies of scale exist when the average cost of producing a good or service declines as more of the good or service is produced. Large firms in some industries are inherently more efficient than small firms because of factors such as the ability to hire specialists rather than jacks-of-all-trades, standardizing repetitive actions, and spreading marketing efforts and expenditures over a larger level of overall output.

* * * * *

Economies of Scale at the Oakmark Mutual Funds

As mentioned previously, mutual fund fees that decrease as assets increase is consistent with economies of scale being realized in the management of mutual funds. With information on the costs of management (rather than the fees charged), an economies of scale analysis can be completed for a family of mutual funds.

The analysis in this section uses the annual accounting data provided by Harris Associates for the years 1999-2003.[9] For the purposes of this analysis, I have looked specifically at the Domestic Mutual Funds business unit. This business unit consists of the domestic Oakmark mutual funds, the sub-advised domestic mutual fund accounts, and the domestic portion of Oakmark and sub-advised global mutual

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[9] Accounting data comes from Bates stamps HA 00099830-9833, HA 0138326-0138330, HA 0138341-0138357

funds. The Oakmark mutual funds represent the majority of the revenues of this business unit. For 2003, the mutual funds accounted for 83% of the revenue in this business unit (called the 200 line of business).[10] The table below shows the line item expenses as detailed in the income statements. The average assets are taken from the monthly assets under management for the Domestic Mutual Funds unit.[11]

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[10] See information at HA 0009808

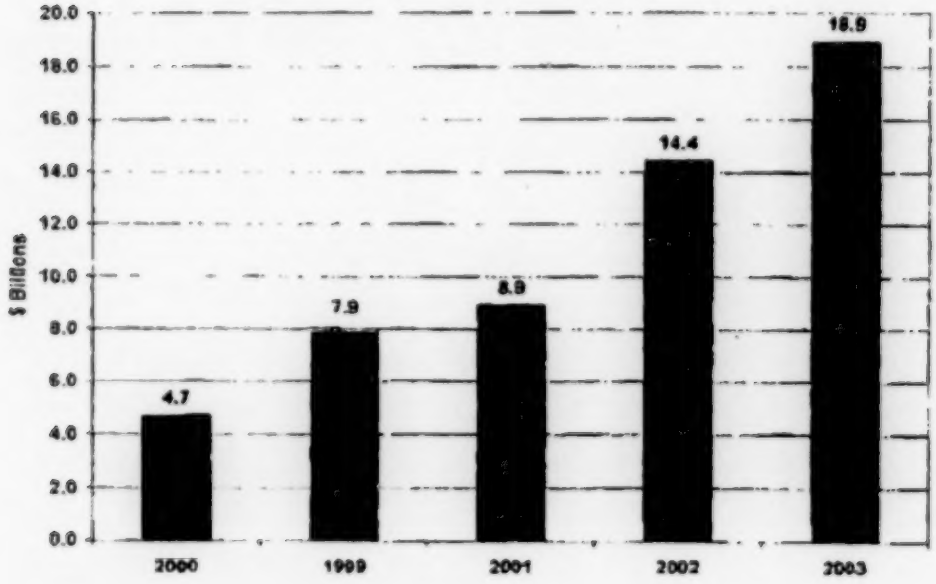
[11] Data on assets under management is from spreadsheets: HA_000000002.xls, HA_000000003.xls, HA_000000048.xls. The spreadsheet for 2005 AUM details specifically the funds that are in the Domestic Mutual Funds unit. Previous versions of the files do not break out domestic from international funds. The 2003 breakdown of domestic vs. international was applied to previous years to identify the funds that were in the domestic funds group. All of the subsequent analysis was duplicated using assets under management for just Oakmark, Select, Equity & Income, Small-cap and 50% of Global. The results are qualitatively similar.

Table 2: Income Statement Data for Domestic Mutual Funds Unit

	1999	2000	2001	2002	2003
PERSONNEL					
Salaries	6,978,110	7,992,870	3,707,620	5,014,502	5,411,052
Bonus	0	0	1,364,034	1,700,752	2,357,668
Group Insurance	398,066	442,504	320,927	585,929	453,853
Profit Share	710,589	767,087	535,847	660,583	757,555
Taxes	279,130	420,658	211,132	316,053	323,172
Other	112,906	143,663	135,174	170,101	131,314
Total Personnel	8,478,801	9,766,782	6,274,734	8,446,020	9,434,614
OCCUPANCY					
Rent	288,977	328,183	194,382	287,723	302,675
Leasehold Maintenance	4,427	10,016	4,252	11,925	11,558
Telephone & Utilities	281,445	187,623	345,728	257,758	147,112
Insurance other than group	74,187	79,755	89,569	255,281	427,311
Depreciation	169,072	376,261	283,018	274,147	328,040
Total Occupancy	818,108	981,838	916,947	1,086,834	1,216,696
MARKETING					
Marketing materials	123,166	807,187	532,480	789,322	514,630
Marketing promotions	129,538	131,072	366,778	409,642	223,677
Fulfill. & Shareholder Svc	241,131	210,312	616,157	626,142	307,153
NTF Program Fees	5,851,585	3,580,398	8,174,130	14,923,943	19,498,971
Mktg Rep Other	12,500	0	0	0	489,561
Total Marketing	6,357,920	4,728,969	9,689,545	16,749,049	21,033,992
OPERATING					
Research & Data	130,523	194,862	93,048	98,268	326,963
Communication Services	0	0	0	32,711	49,192
License Fees	0	0	0	74,427	45,591
Business Resumption	0	0	0	2,609	39,914
Furniture & Equipment	49,035	44,881	22,607	24,437	22,741
Computer & Software	22,781	50,122	27,468	26,601	44,715
Postage	139,941	101,530	46,147	47,028	27,942
Supplies & Office Services	403,697	131,583	71,829	108,672	87,577
Consumables	59,043	60,407	36,700	57,831	51,276
Subscriptions	43,528	37,889	23,041	44,107	58,213
Assoc., Club. Prof. Dues	25,818	26,956	36,855	26,281	44,720
Travel & Entertainment	601,252	560,899	468,999	379,099	309,002
Consulting, Recruiting	118,520	170,456	236,575	234,020	192,285
Charitable Contributions	400	38,709	26,837	25,115	45,017
Legal, Audit & Registration	27,114	219,354	186,900	183,063	366,249
Interest Expense	0	240,144	5,859	1,222	0
Errors	-582	537,253	27,379	0	79,695
Other Expenses	89,702	61,154	119,855	90,852	46,089
Use & Other Tax	0	105,758	-40,466	7,563	15,210
Restructuring	0	0	0	0	75,000
Total Operating	1,710,772	2,582,047	1,391,631	1,463,926	1,927,391
Total Expenses	33,018,430	33,537,225	35,754,083	54,031,732	65,297,995
Total Non-marketing expenses	11,005,681	13,330,887	8,583,312	10,998,780	12,578,701
Deferred Comp	6,584,212	5,141,404	9,240,277	14,650,816	16,300,254
Discretionary pool	16,940,573	9,250,082	20,058,311	29,361,652	35,318,245
Total Pool	23,524,785	14,391,486	29,298,588	44,021,468	51,618,499
Average Assets	7,900,731,214	4,702,954,045	8,918,374,851	14,443,305,047	18,907,837,879

The average assets at these funds fell from 1999 to 2000 and then rose in 2001, 2002 and 2003. The graph below illustrates the average asset levels in each year. Note that the years 1999 and 2000 are transposed to cause the graph to show increasing asset levels, as you move to the right. This simply allows an easier comparison of changes in asset levels to the revenues and expenses that will be analyzed.

Figure 4: Average Assets in Domestic Mutual Funds Unit



As previously discussed, economies of scale occur when the costs decline, on a percentage basis, as the assets increase. We can look at several of these expense categories graphically to illustrate economies of scale in the management of the Domestic Mutual Funds unit. The following graphs show the various expenses of the Domestic Mutual Funds unit as a percent of the average assets under management.

Figure 5: Personnel Expenses as a Percent of Average Assets in Domestic Funds Unit

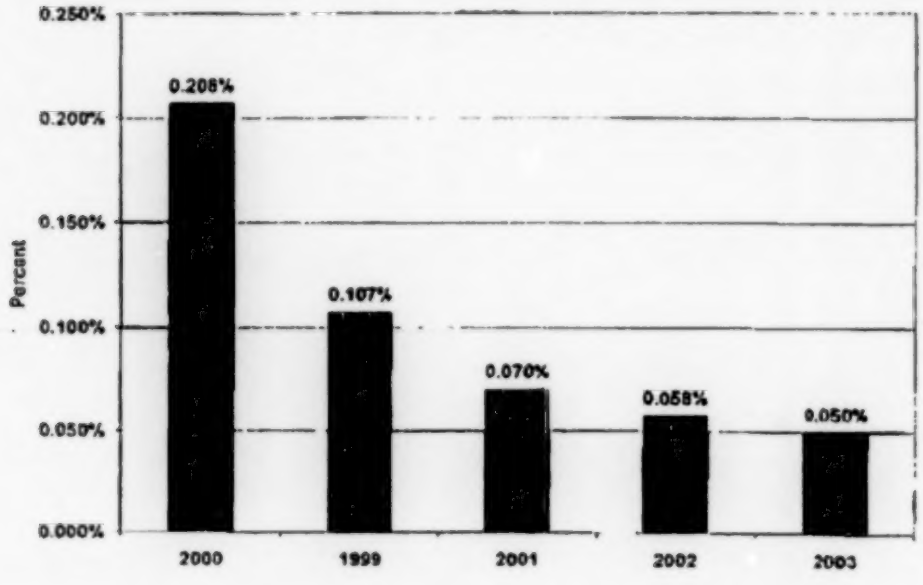


Figure 6: Occupancy Expenses as a Percent of Average Assets in Domestic Funds Unit

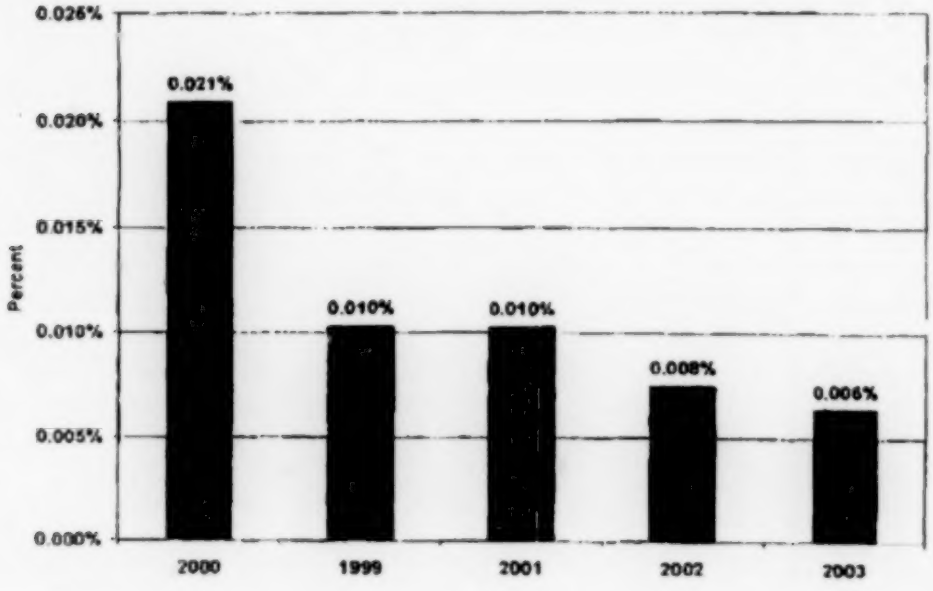


Figure 7: Operating Expenses as a Percent of Average Assets in Domestic Funds Unit

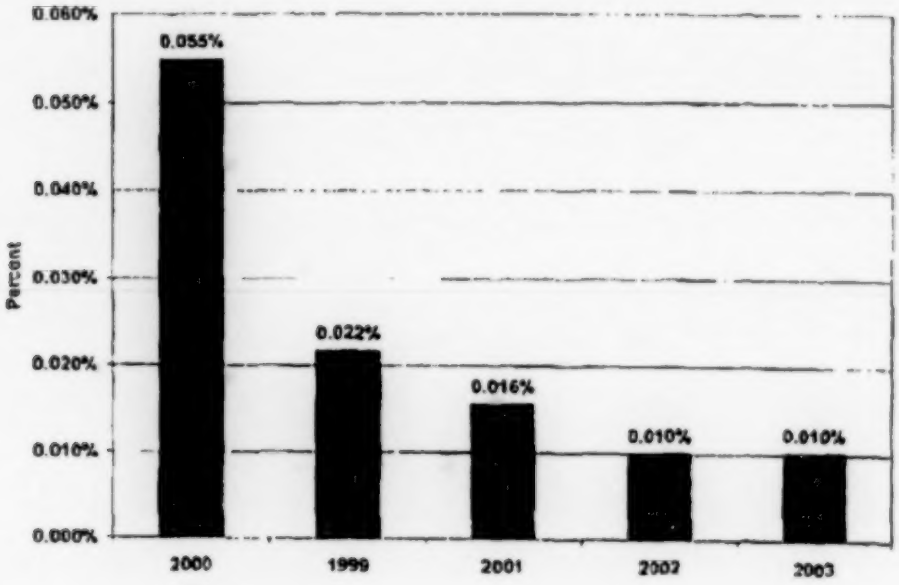


Figure 8: Marketing Expenses as a Percent of Average Assets in Domestic Funds Unit

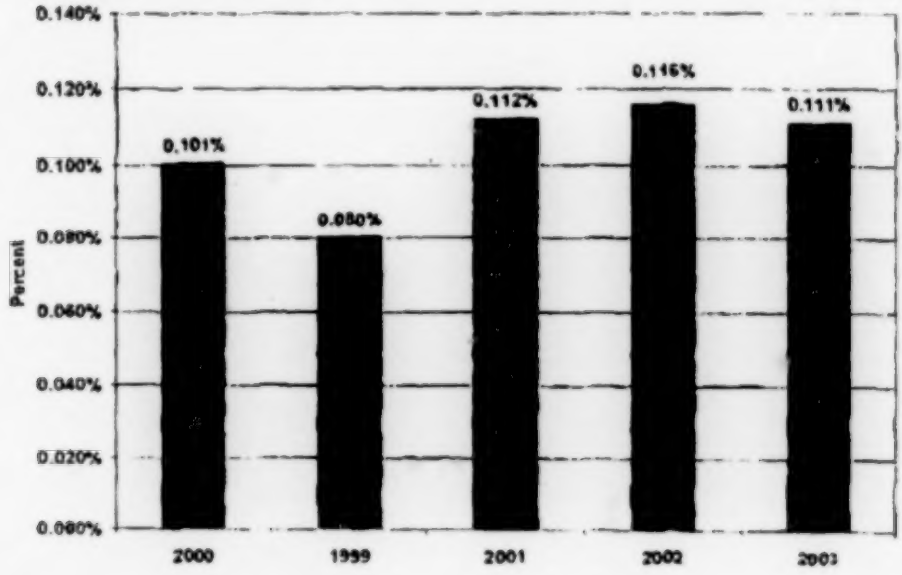
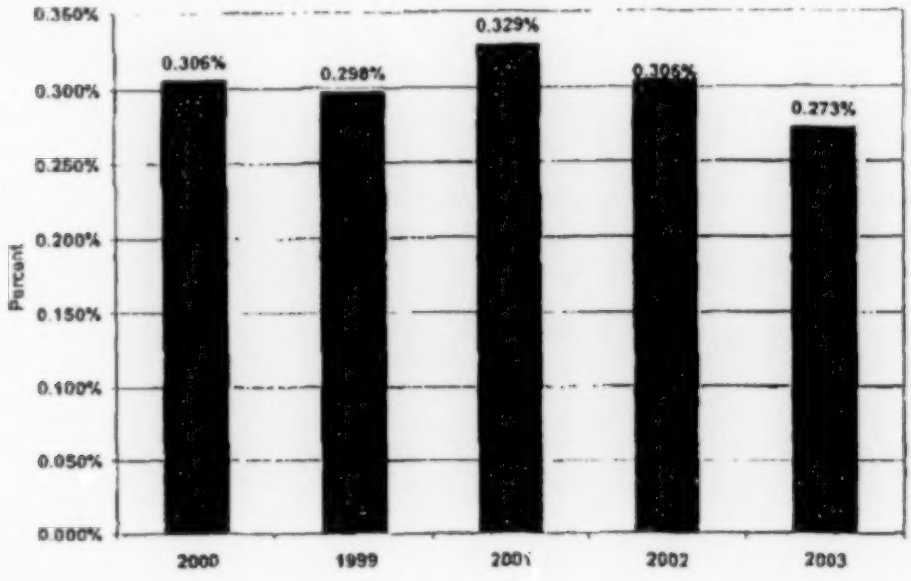


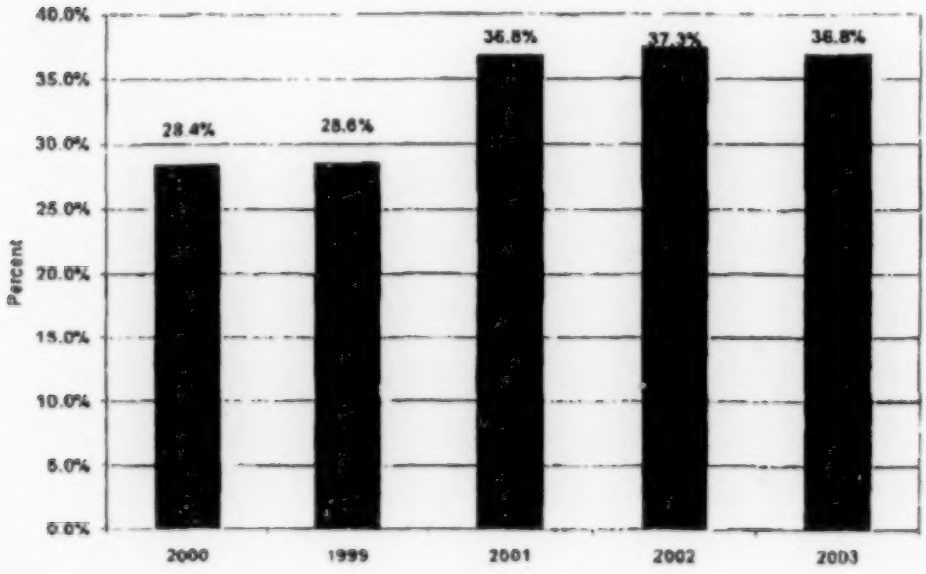
Figure 9: Total Pool allocations as a Percent of Average Assets in Domestic Funds Unit



Personnel, occupancy and operating expenses all decline substantially with the asset growth over this time period indicating that economies of scale are being realized. If we group these three expense categories together into a category called "Non-marketing Expenses," we find that these expenses together were .283% in 2000 and declined to .067% in 2003. This is a decrease of 21.6 basis points and is a decrease of 76% of year 2000 non-marketing expenses. Marketing expenses, which arguably benefit the advisor rather than the funds, rise by 1 basis point (a 10% increase over year 2000 levels). Pool allocations, which include deferred compensation and the discretionary pool, decrease marginally over these asset levels (the decrease is approximately 3 basis points from 2000 asset levels to 2003 asset levels). Note that the rise in assets from $4.7 B to $18.9B is fueled not only by assets in the Oakmark funds, but also by assets in sub-advised products. In 2000, when assets were $4.7 B, the assets in the Oakmark funds (Oakmark, Select, Equity & Income, Small-cap and 50% of

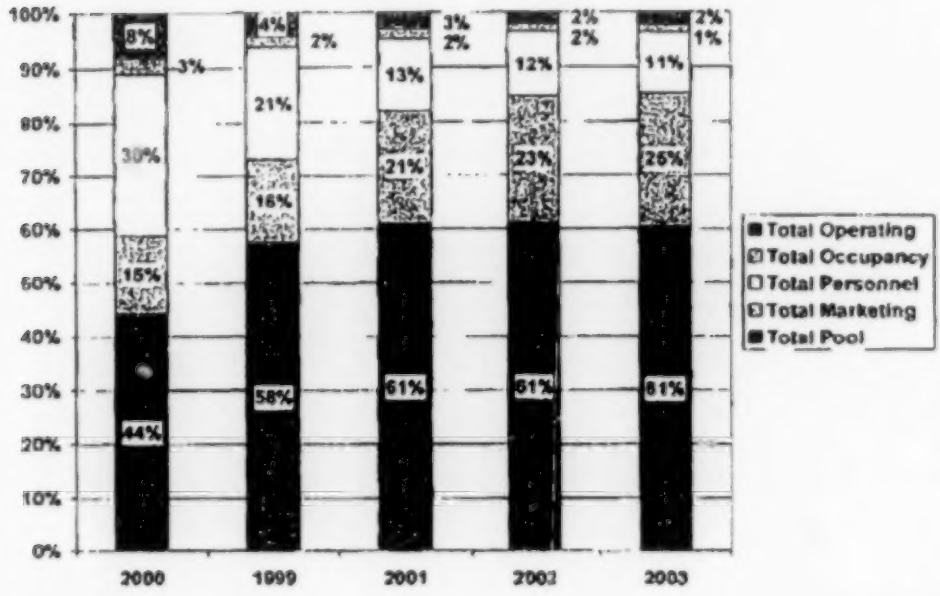
Global) were $4.1 B. This accounts for 87% of assets in the domestic funds unit. In 2003, the $18.9 B in assets consisted of $13.9 B in the Oakmark funds and $5 B in sub-advised funds. Thus the portion of assets under management that were in sub-advised products increased substantially from 13% when assets were at $4.7 B to 26% when assets were $18.9 B. Because the sub-advised products generate lower fees for Harris, the revenues derived from the higher level of assets did not completely keep pace with the growth of the assets themselves. Slower revenue growth (due to increased sub-advisory contracts) than asset growth causes total pool allocations to decline marginally relative to assets over this time period. However, this decline is simply an artifact of the increased sub-advisory assets in the total assets under management in this unit. If we look at the ratio of total pool allocations to revenues, we see that pool allocations are increasing with revenues over this period.

Figure 10: Total Pool allocations as a Percent of Revenues in Domestic Funds Unit



Also of interest is to see how the various components of expenses (and the total pool allocations) behave as a percent of all expenses. The chart below sums all expense categories and the pool allocation and quantifies each separate component as a percent of the sum.

Figure 11: Expense categories as a Percent of Total Expenses



In 2000, when assets were $4.7 B in the business unit, Operating, Occupancy and Personnel expenses were 41% of total expenses and pool allocations. When assets grew to $18.9 B, these three expense categories constituted only 13% of total expenses. Marketing expenses plus pool allocations grew from 59% to 86% over this asset range.

Institutional Separate Accounts at Harris

In addition to serving as the advisory company for the Oakmark funds, Harris Associates also sells sub-advisory services and institutional separate account management. In a sub-advisory arrangement, the

advisor to a mutual fund contracts out the portfolio management responsibilities to another firm. In most cases the sub-advisor provides only the portfolio management service. Institutional accounts include sub-advisory accounts, but also include accounts that are managed for institutional and high-net-worth investors that are not a mutual fund. Harris has both mutual fund sub-advisory contracts as well as other institutional separate accounts.

Harris presented to the board a comparison of management fees between the Oakmark funds and various large institutional investors in the same objective category.[12] In addition, Harris has provided through discovery documents which show institutional accounts with investment objectives, fee schedules and assets under management.[13] The documents show that, the management fees for large institutional accounts can be significantly lower than for the Oakmark funds. Additionally, it is important to note that the mutual funds are all much larger than the institutional accounts to which they are compared. Since larger investors are generally able to obtain more favorable fee schedules, it is reasonable to expect that the funds could obtain schedules at least as favorable as those detailed below.

Oakmark Fund

The Oakmark Fund is a Large Cap fund and is compared by Harris to Large Cap strategy institutional accounts. The largest large cap institutional account which has a fee schedule is called "Client #2."[14] The

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[12] Bates stamps HA0000437 to 0000455

[13] Bates stamps HA0135013X to 0135027X, HA0135028A, and HA0135007 to 0135012

[14] Bates stamp HA0000438

table below shows the fee schedules for the Oakmark Fund and for Client #2. Also shown is the effective fee that HALP would earn on the assets under management as of 6/30/04.

Table 3: Comparison of Oakmark Fund with Large Cap Institutional Account

Fund/ Client	Fee Schedule	HALP Effective Fee	AUM
Oakmark Fund	1.00% up to $2.0B 0.90% on next $1.0B 0.80% on next $2.0B 0.75% over $5.0B	0.88%	$6.3B
Client 2	0.50% up to $50M 0.45% on next $50M 0.40% on next $50M 0.35% over $150M	0.45%	$160M

If the Oakmark Fund were subject to the same fee schedule as Client #2, the effective fee for the Oakmark Fund would be 0.352%. This fee is less than half of the fee charged to the Oakmark Fund shareholders. The difference in these fees is 0.528%.

Equity & Income Fund

The Oakmark Equity & Income Fund is compared to institutional accounts with a Balanced strategy. The largest institutional account with a balanced strategy is coded as "Client $1."[15] Client #1 has large cap stocks as the equity portion of the balanced account. The Oakmark Equity & Income Fund also holds primarily large cap stocks. The fee schedules for the

[15] Bates Stamp HA0000440

Oakmark Equity & Income Fund and for Client #1 are shown in the table below:

Table 4: Comparison of Oakmark Equity & Income fund with Balanced Institutional Account

Fund/ Client	Fee Schedule	HALP Effective Fee	AUM
Oakmark Equity & Income Fund	0.75% up to $5.0B 0.70% on next $2.5B 0.675% on next $2.5B 0.65% over $10.0B	0.73%	$7.7B
Client #1	0.35% up to $100M 0.30% on next $400M 0.25% over $500M	0.31%	$429M

If the Oakmark Equity & Income Fund were subject to the same fee schedule as Client #1, the effective fee for the Oakmark Equity & Income Fund would be 0.254%. This fee is 0.476% lower than the fee charged to the Oakmark Equity & Income Fund shareholders.

Global Fund

The Oakmark Global Fund is compared to institutional accounts with a global strategy. The largest institutional account with a global strategy is coded as "Client #1."[16] The fee schedules for the Oakmark Global Fund and for Client #1 are shown in the table below:

[16] Bates stamp HA 0000442

Table 5: Comparison of Oakmark Global Fund with Global Institutional Account

Fund/ Client	Fee Schedule	HALP Effective Fee	AUM
Oakmark Global Fund	1.00% up to $2.0B 0.95% on next $2.0B 0.90% over $4.0B	1.00%	$1.4B
Client #1	0.85% up to $25M 0.70% on next $25M 0.60% on next $50M 0.50% over $100M	0.61%	$167M

If the Oakmark Global Fund were subject to the same fee schedule as Client #1, the effective fee for the Oakmark Global Fund would be 0.513%. This fee is 0.487% lower than the fee charged to the Oakmark Global Fund shareholders.

The investment management of a separate account is very similar to that of a mutual fund. Most of the separate accounts are managed with the same objective as one or more of the Oakmark funds. For Harris, research conducted on securities serves both the mutual fund and the separate accounts. The managers for both the funds and the separate accounts are given the same research information and sit in on the same stock selection meetings.[17] In some cases the stocks that are held in a separate account are completely duplicated in a mutual fund with the same objective.[18] There is virtually no difference in the day-to-day management activities between the mutual funds and the separate accounts.

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[17] See Deposition of Henry R. Berghoef, pages 33-37, 153-157.

[18] See Bates stamp HA S000127577

Summary

In the analysis above, I have identified conservative estimates of the investment management fees that accounts the size of the Oakmark funds at issue in this case could reasonably expect to obtain according to the fees offered to separate account clients. Importantly, the funds are much larger than the separate accounts. The large size would give the funds the ability to negotiate investment management fees that would likely be significantly lower than the standard fees offered to smaller separate accounts. The table below summarizes these findings.

Table 6: Differences in Actual Oakmark 2004 Management Fees and Fees Calculated from Institutional Account Fee Schedules

Funds	Style	HALP Effective Fee (%)	Fee consistent with Institutional Account fee schedules (%)	Difference between HALP Effective fee and Separate Account (%)
Oakmark Fund	Large Cap	0.88	0.352	0.528
Equity & Income Fund	Balanced	0.73	0.254	0.476
Global Fund	Global	1.00	0.513	0.487
AVERAGE				0.497

* * * * *

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

REBUTTAL EXPERT REPORT[1]
EDWARD S. O'NEAL, PH. D.

I have been engaged by the counsel to the plaintiffs to provide rebuttal analysis and opinions about the analysis and testimony of Ajay Khorana, one of defendant's experts. Information regarding my compensation is set forth in my Preliminary Expert Report ("expert report"), which was served in this case on January 30, 2006 and is incorporated herein by reference. My qualifications and expertise are discussed in my resume, which is attached as Exhibit A to my expert report.

* * * * *

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[1] Analysis of these issues in ongoing. The observations, analysis and conclusions of this report may change as additional data is made available and analyzed. In addition, I reserve the right to prepare charts and graphs as demonstrative exhibits using the data relied upon in the preparation of this report.

II. Competition in the mutual fund industry

* * * * *

28. Dr. Khorana criticizes my use of cost accounting data in the economies of scale analysis conducted in my expert report.[36] According to Dr. Khorana, my economies of scale are exaggerated because Harris changed accounting systems between 2000 and 2001. Harris reported all mutual fund expenses in the Domestic Mutual Funds unit prior to 2001 rather than reporting expenses separately for the International Group unit and the Domestic Mutual Funds unit as was the case in 2001-2003. Interestingly, Dr. Khorana does not recreate the analysis, but simply criticizes it. I have recreated the analysis by combining in 2001-2003 the expense and average asset numbers of the Domestic Mutual Funds unit and International Group units.[37] Exhibits 3 through 11

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[36] See Khorana Report, paragraph 57.

[37] In 1999 and 2000, assets for international mutual funds and domestic funds were reported together and did not include assets in the Investment Advisory unit. Expenses reported in these years for the International Group were reported with the Domestic Mutual Fund unit and also did not include expenses for the Investment Advisory unit. In 2002 and 2003, expenses were reported separately for the Domestic Mutual Funds unit and the International Group unit. The International Group unit expenses also include the portion of the sub-advised products that have an international objective. Therefore, to be consistent in these years, I include the assets that are in Sub-advisory – International along with the assets reported for the Mutual Funds – Domestic and Mutual Funds – International. In 2001, assets were reported as in 2000 but expenses were reported as in 2002. For 2001 I use the expense data as reported for Domestic Mutual Funds and International Group (which includes expenses for sub-advised international products). I use the assets reported for Mutual Funds (which includes both international and domestic mutual funds) and estimate the

show the analysis in the same graphical format included in my original report. The conclusions drawn from this analysis are qualitatively the same as the conclusions drawn in my original report:

- "Personnel, occupancy and operating expenses all decline substantially with the asset growth over this time period indicating that economies of scale are being realized."[38]
- "If we look at the ratio of total pool allocations to revenues, we see that pool allocations are increasing with revenues over this period."[39]
- In 2000, when assets were $5.7 B in the business unit, Operating, Occupancy and Personnel expenses were 41% of total expenses and pool allocations. When assets grew to [$26.7 B], these three expense categories constituted only [15%] of total expenses. Marketing expenses

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portion of Investment Advisory assets that are in international products. This estimate is the sum of assets in HALP International Partnership and 10.6% of the assets in the product called "Institutional." This "Institutional" product in 2002 was divided up into a portion that was international and a portion that was domestic. As of January of 2002, the international portion of the product represented 10.6% of the total assets in the domestic and international "Institutional" products combined. I have assumed that 10.6% is best estimate of the split between the domestic and international portion of the "Institutional" product in 2001. Note that this process requires that 2001-2003 include the international subadvisory products (both assets and expenses) while those products are not included in 1999-2000. However, these subadvisory assets and expenses are small relative to the assets at the mutual funds and their inclusion or exclusion would not affect my opinions in this case.

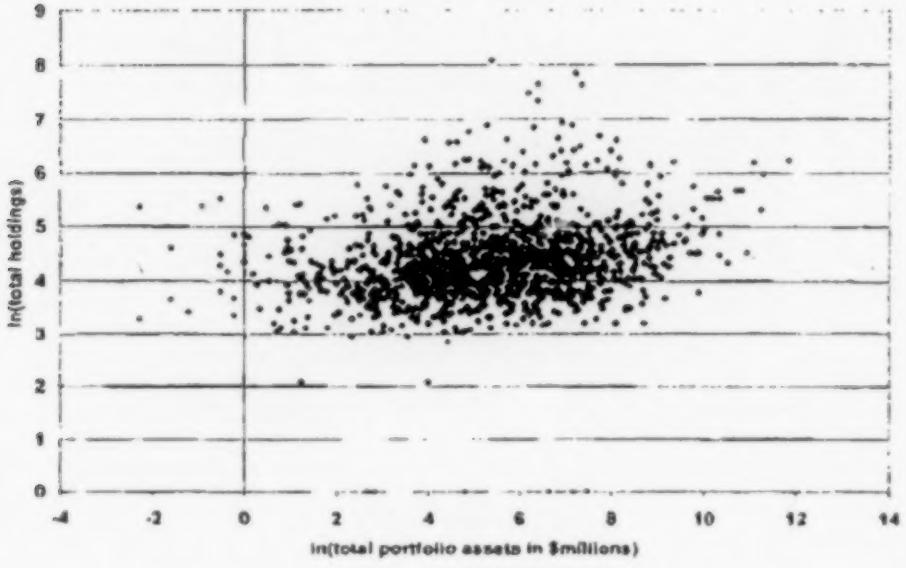
[38] See O'Neal expert report at page 15.

[39] See O'Neal expert report at page 16.

plus pool allocations grew from 59% to [84%] over this asset range.[40]

29. Dr. Khorana suggests that a lack of a statistical test on the above analysis somehow constitutes a flaw in the analysis.[41] I disagree with Dr. Khorana. My analysis demonstrates conclusively that expenses at the Harris mutual funds unit decreased as assets under management increased. Dr. Khorana also shows that expenses decreased as assets under management increased. These independent findings demonstrate that economies of scale were realized by Harris over this time period.

Exhibit 1: Relationship between natural log of total fund holdings and natural log of total fund portfolio assets



[40] See O'Neal expert report at page 17. Bracketed numbers represent changes from original expert report and are minor.

[41] See Khorana report, paragraph 58.

Exhibit 2: Predicted number of portfolio holdings based on total portfolio assets

Total Portfolio Assets ($M)	Predicted number of holdings
100	74
200	79
300	82
500	85
1,000	90
2,000	96
3,000	99
5,000	104
10,000	110
20,000	116
30,000	121
50,000	126
100,000	133

Exhibit 3: Combined Income Statement Data for Domestic and International Fund Units

	1999	2000	2001	2002	2
Salaries	6,978,110	7,992,870	5,285,688	7,650,694	8,562,
Bonus	0	0	2,361,826	3,003,782	3,338,
Group Insurance	398,066	442,504	529,478	856,386	705,
Profit Share	710,589	767,087	878,615	1,029,966	1,225,
Taxes	279,130	420,658	348,403	495,776	556,
Other	112,906	143,603	207,361	250,823	223,
Total Personnel	8,478,801	9,766,782	9,611,571	13,287,407	14,611,
Rent	280,977	328,183	312,701	431,561	450,
Leasehold Maintenance	4,427	10,016	6,864	17,222	19,
Telephone & Utilities	281,445	187,623	417,684	308,822	290,
Insurance other than group	74,187	79,755	108,316	292,374	569,
Depreciation	169,072	376,261	351,605	366,840	495,
Total Occupancy	810,108	981,838	1,197,170	1,416,819	1,731,
Marketing materials	123,166	807,187	960,527	966,393	625,
Marketing promotions	129,538	131,072	418,451	450,065	268,
Fulfillment & Shareholder Services	241,131	210,312	662,471	720,084	370,
NTF Program Fees	3,651,585	3,580,398	9,145,682	17,346,217	23,696,
Mktg Rep Other	12,500	0	0	0	2,498,
Total Marketing	6,357,920	4,728,969	11,187,131	19,482,739	27,458,
Research & Data	130,523	194,862	121,180	153,953	410,
Communication Services	0	0	0	47,578	72,
License Fees	0	0	0	105,382	78,
Business Resumption	0	0	0	3,914	60,
Furniture & Equipment	49,035	44,881	32,613	34,608	33,
Computer & Software	22,781	50,122	40,130	40,465	69,
Postage	139,941	101,530	60,281	70,670	46,
Supplies & Office Services	403,697	131,583	106,587	158,351	136,
Consumables	59,043	60,407	50,703	84,668	66,
Subscriptions	43,528	37,859	27,459	56,384	81,
Assoc., Club, Prof Dues	25,818	26,956	46,436	32,860	54,
Travel & Entertainment	601,252	580,899	772,030	656,813	553,
Consulting, Recruiting	118,520	170,456	309,537	326,927	266,
Charitable Contributions	400	38,709	41,905	28,268	52,
Legal, Audit & Registration	27,114	219,354	251,631	285,548	475,
Interest Expense	0	240,144	187,448	1,232	
Errors	-582	537,253	79,799	9,943	79,
Other Expenses	89,702	61,154	276,902	115,110	92,
Use & Other Tax	0	105,758	-47,888	9,525	21,
Restructuring	0	0	0	0	121,
Total Operating	1,710,772	2,582,047	1,761,959	2,202,203	2,795,
Total Expenses	33,016,430	33,537,225	45,753,703	70,576,133	90,399,
Total Non-marketing expenses	11,005,681	13,330,667	17,374,992	25,645,288	35,398,
Deferred Comp	6,584,212	5,141,404	10,498,204	18,456,631	22,694,
Discretionary pool	16,940,573	9,250,082	19,770,153	35,657,307	49,619,
Total Pool	23,524,785	14,391,486	30,268,357	54,113,938	72,313,
Average AUM	5,731,954,045	8,937,731,214	10,358,374,851	18,459,305,047	26,702,837,

Exhibit 4: Average Assets ($B) in Combined Domestic and International Funds Units

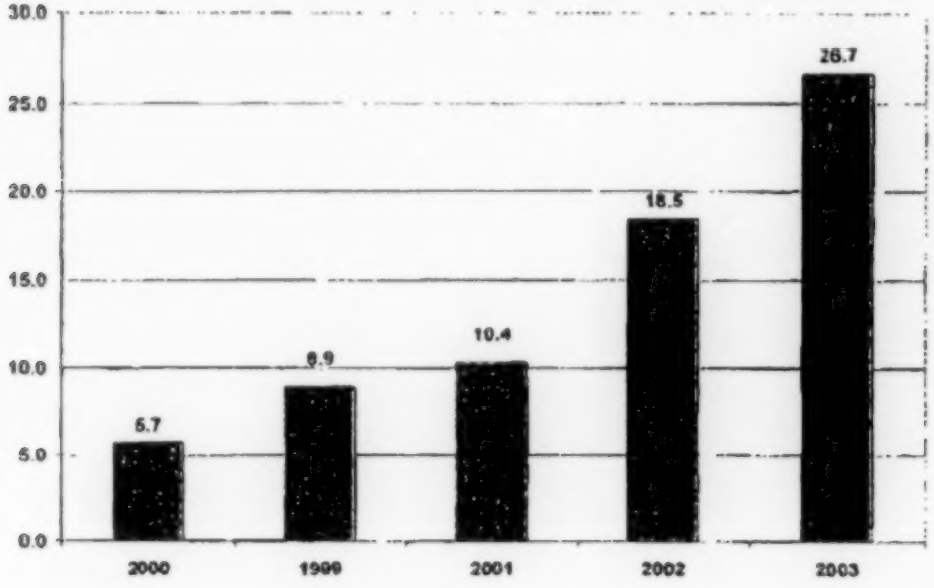


Exhibit 5: Personnel Expenses as a percent of Average Assets in Combined Domestic and International Funds Units

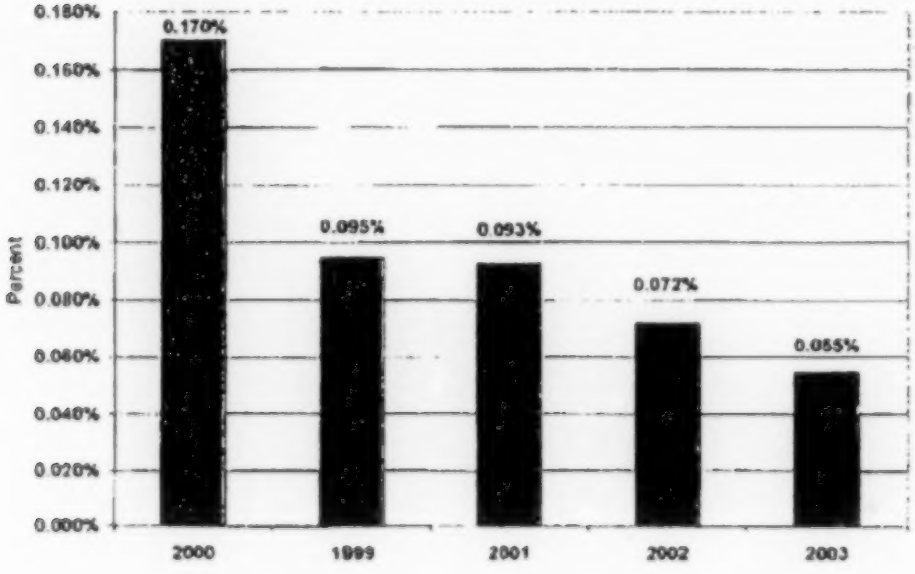


Exhibit 6: Occupancy Expenses as a percent of Average Assets in Combined Domestic and International Funds Units

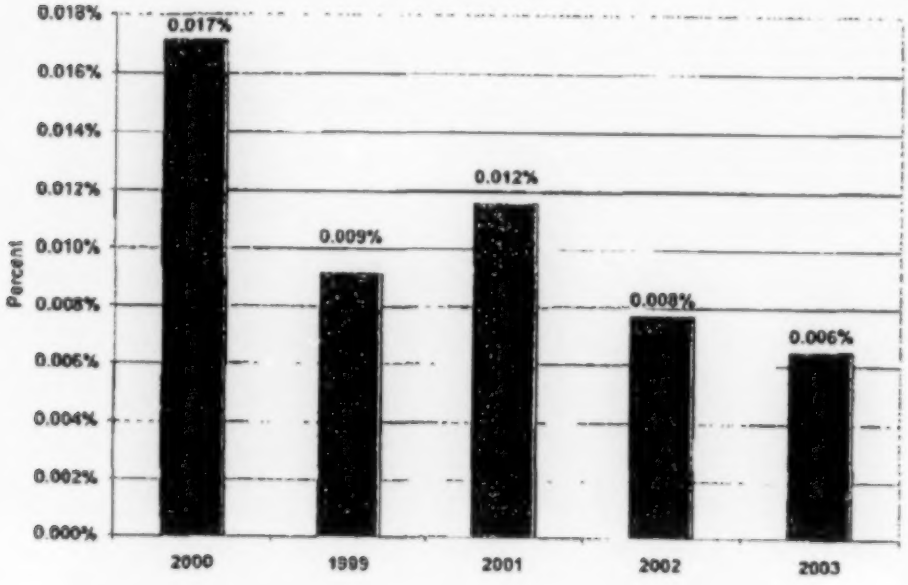


Exhibit 7: Operating Expenses as a percent of Average Assets in Combined Domestic and International Funds Units

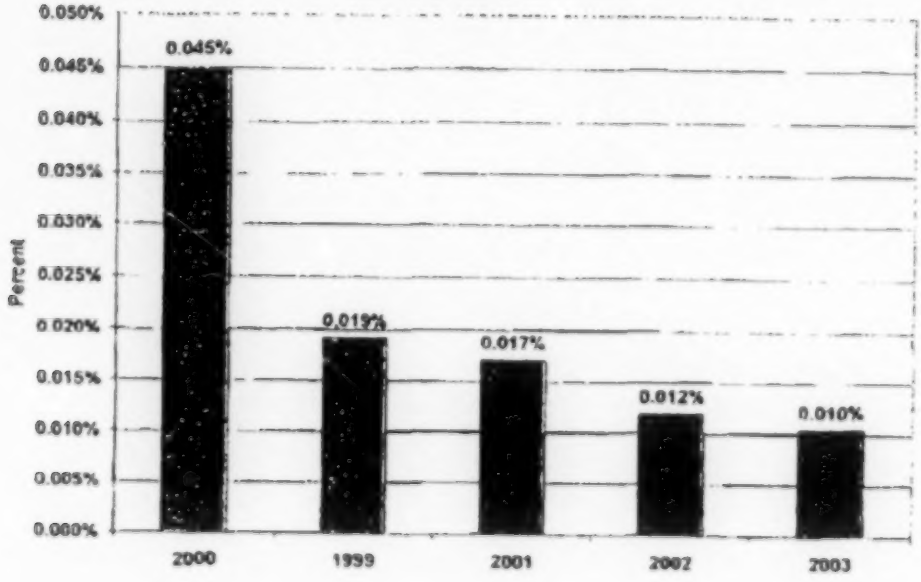


Exhibit 8: Marketing Expenses as a percent of Average Assets in Combined Domestic and International Funds Units

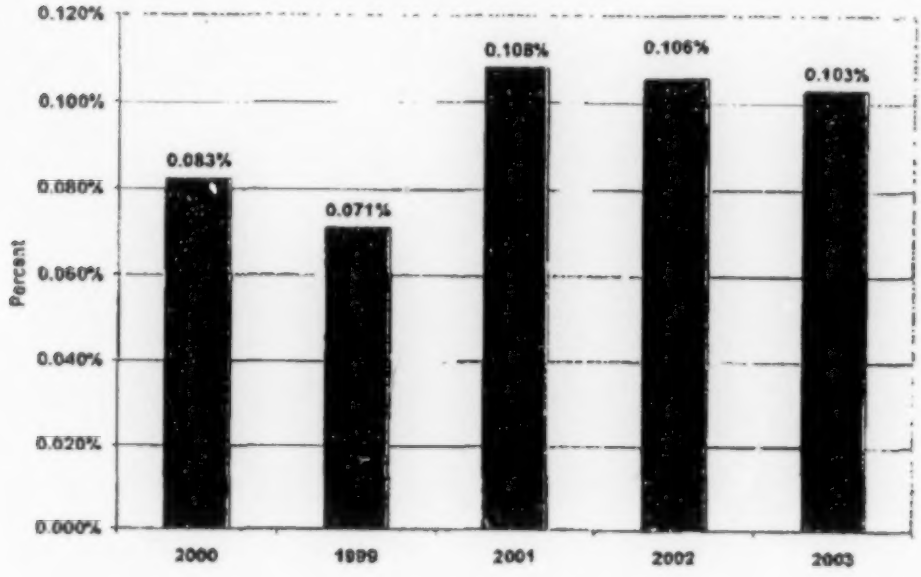


Exhibit 9: Total Pool Allocations as a percent of Average Assets in Combined Domestic and International Funds Units

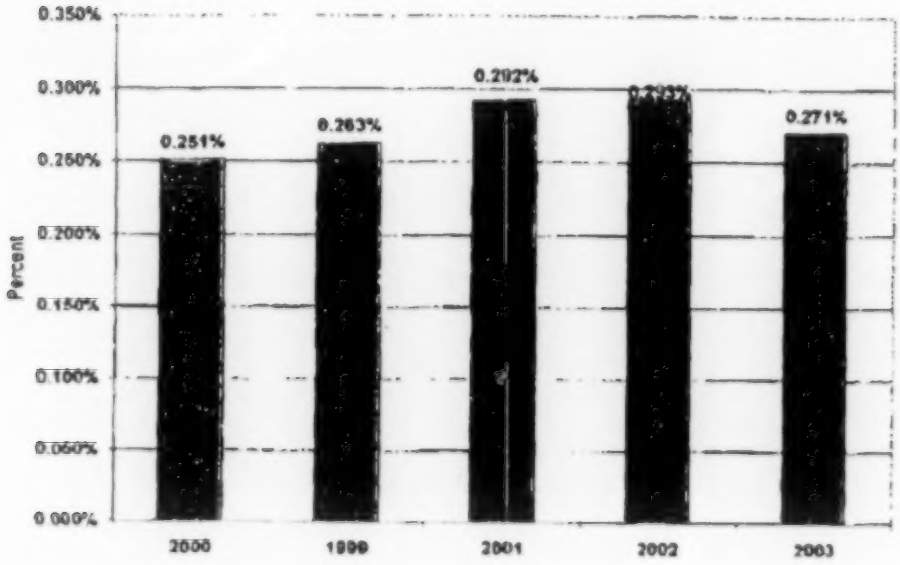
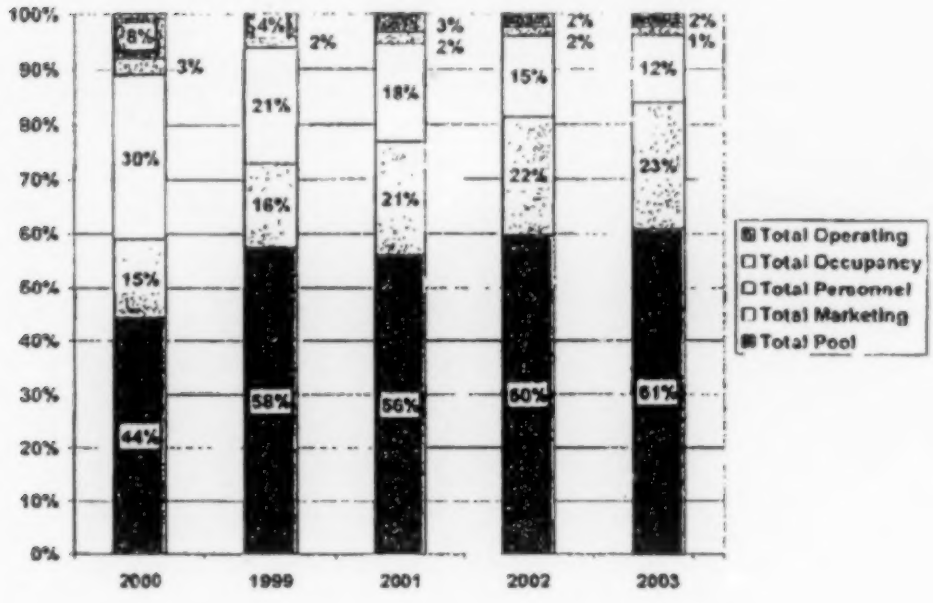


Exhibit 10: Expense Categories as a percent of Total Expenses



This rebuttal report in the case of JERRY N. JONES, et al. v. HARRIS ASSOCIATES, L.P., is respectfully submitted.

/s/ EDWARD S. O'NEAL

Edward S. O'Neal

EXHIBIT A-6

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION
Case No. 1:04-cv-08305 CPK

JERRY N. JONES, et al.,
Plaintiffs,

vs.

HARRIS ASSOCIATES L.P.,
Defendant.

JANUARY 30, 2006

Steve Pomerantz, LLC

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Expert Report of Steve Pomerantz

* * * * *

This report is offered pursuant to Federal Rule of Civil Procedure 26(a)(2) and is authored by Dr. Steven Pomerantz, president of Steve Pomerantz LLC, an economic and financial consulting firm located in Princeton, New Jersey. The author's CV and a list of court appearances are attached to this report as Exhibit 1.

Qualifications

I have worked in the investment community since 1986. I have held positions in research and management for fixed income, equities, derivatives and alternative investments at several major firms including Weiss Peck and Greer, New York Life Investment Management, Citibank, and Morgan Stanley, and am currently the Director of Risk Management at Gordon Asset Management — a fund of funds. I have spoken at investment seminars, presenting on various areas of portfolio management, risk management, asset allocation, hedge funds products, and securities pricing. I hold a Ph.D. in mathematics from the University of California at Berkeley and have taught courses in statistics, probability, operations research and finance at the undergraduate and graduate level.

Scope

I have been retained by Plaintiffs' legal counsel on behalf of Jerry N. Jones *et al.* to provide expert testimony concerning the pricing of services rendered to several Oakmark mutual funds ("the Funds") by the Funds' investment advisor, Harris Associates L.P. ("HALP"). The Funds analyzed as part of this report include: Oakmark, Oakmark Global and Oakmark Equity & Income. These funds represent a range of investment styles including large cap, international, and balanced investing. As part of this assignment I have formed opinions about the reasonableness of the fees paid by the Funds for portfolio management services, including the extent to which economies of scale have been shared with the Funds' shareholders. In addition, I have been asked to offer an opinion on

the difference in performance between the Funds and their institutional composite counterparts.

I am compensated for my work at a rate of $350 per hour plus out of pocket expenses. My compensation is in no way contingent upon my opinions or the testimony I intend to offer in this case.

A list of documents reviewed in this matter is contained in Exhibit 2.

Summary of Conclusions

- The existence of economies of scale in the mutual fund business is well documented by industry sources as well as by internal HALP records.
- The benefits of economies of scale are not being passed through in any meaningful way to the shareholders of the Funds named in this lawsuit.
- HALP provides virtually identical investment advisory services to its Institutional Accounts at fees substantially lower than those charged to shareholders of the Funds.
- The information being provided to the boards of the Funds on these issues is incomplete and misleading.

Overview of Economies of Scale

An economy of scale is a reduction in the cost per unit resulting from increased production that is realized through operational efficiencies. In this case, the unit is the management of incremental dollars that are being provided with portfolio management services.

Economies of scale most often occur in the manufacture of a product that has significant fixed costs. When this is so, as the business grows, those costs can be allocated to progressively more units, thus lowering the per unit cost. Costs incurred by mutual funds are typically divided into two components, advisory and administrative costs.

Advisory costs, which are the focus of this analysis, are highly fixed in nature. The portfolio management process consists of several steps, the cost of which will be shared by increasingly more assets under management as the assets of a mutual fund grow. The portfolio managers, analysts, technologists and support staff required to manage funds remain relatively fixed regardless of the amount of assets being managed. The same decisions and systems are required for virtually any level of assets. Furthermore, if assets grow through market appreciation, portfolio and client management service costs do not change.

Background of the Case

The plaintiffs are shareholders in several Oakmark mutual funds, which are registered open-ended investment companies created, sold, advised and managed by HALP. These Funds are representative of the styles of mutual funds, as well as institutional accounts, managed by the advisor. Plaintiffs indirectly pay an annual fee for services rendered to the Funds by HALP, which is assessed against fund assets. Mutual fund fees are typically divided into two main parts: advisory fees and administrative or shareholder servicing expenses.

The "advisory fee" is the cost of providing the actual money management function. Such services would primarily include the cost of portfolio managers,

analysts, traders, required technology, and technical and staff support for advisory functions.

The administrative expenses typically encompass the costs of providing funds with accounting, auditing, directors' compensation, transfer agency, custody, record keeping and other shareholder services, and legal services.

For purposes of this analysis, HALP has two sets of clients. The first invests through mutual funds bearing the Oakmark name; the second set includes those who invest through individually managed accounts, either by way of sub-advisory agreements between HALP and the advisor of a non-HALP mutual fund or by way of investment management agreements between HALP and a qualified retirement plan or group trust. The second type of client is hereinafter collectively referred to as the "Institutional Accounts." The advisory services provided to the Funds by HALP are essentially identical to those provided by HALP to the Institutional Accounts and entail virtually the same costs. However, the advisory fees charged to the Institutional Accounts are substantially lower than those charged to the shareholders of the Funds. The higher fees for the Funds result in profits to HALP that are higher than would have accrued if fees were set competitively.

The Oakmark funds, like most mutual fund complexes, rely on an external fund manager (HALP) for most of the services provided.[1] This external management structure, which is very common in the fund

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[1] John C. Bogle, Mutual Funds Industry Practices and their Effect on Individual Investors. Testimony before Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. March 12, 2003.

industry, introduces an inherent conflict of interest between the advisor and the fund. Simply put, each dollar of extra advisory fee charged produces income to the advisor but depletes the funds' assets, thereby reducing the Fund shareholders' equity.

* * * * *

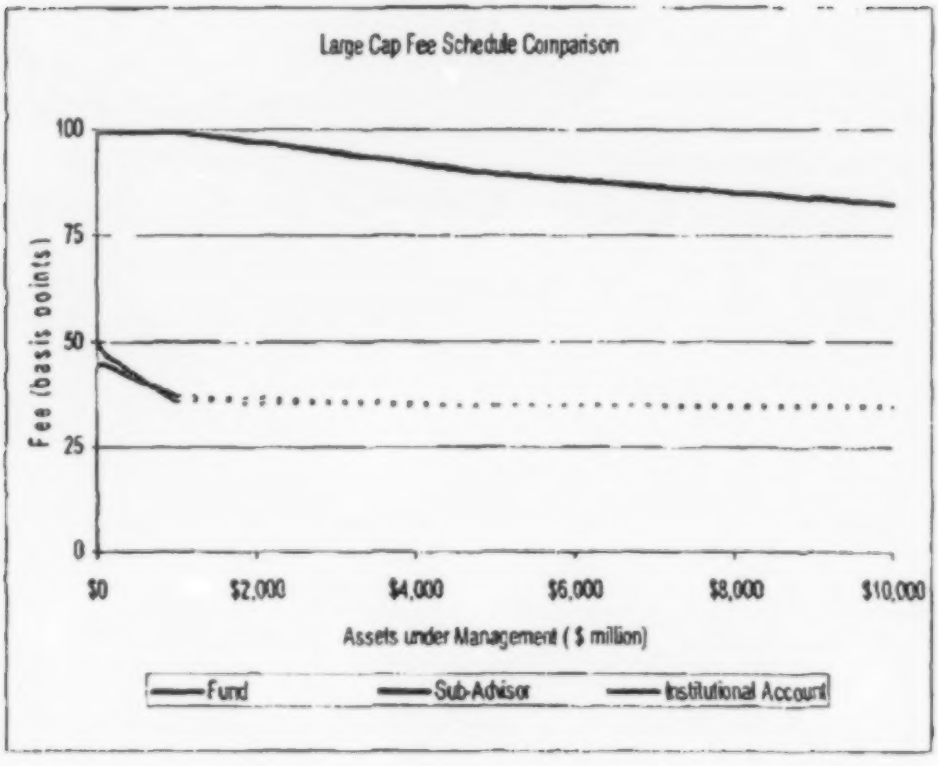
Economies of Scale Also Exist at HALP

The chart below summarizes the advisory fee at various asset levels for Institutional Accounts, as compared to the Oakmark Fund, which are managed in the large cap equity style. The advisory fee schedule is listed here for comparative purposes[6] and will be discussed later in greater detail.

Account Size ($million)	Advisory fee for Institutional accounts	Advisory fee for Sub-Advised accounts	Advisory Fee for Mutual Fund
10	50	45	100
100	48	45	100
1000	37	38	100
10000	35	35	83

[6] HA 0000438

These values are also illustrated below:



As the graph clearly illustrates, fees decline dramatically as assets under management increase for Institutional Accounts but hardly move at all for the Oakmark Fund.[7] Applying these fee schedules to the assets managed produces the following illustration of the actual dollar fee charged for providing advisory services.

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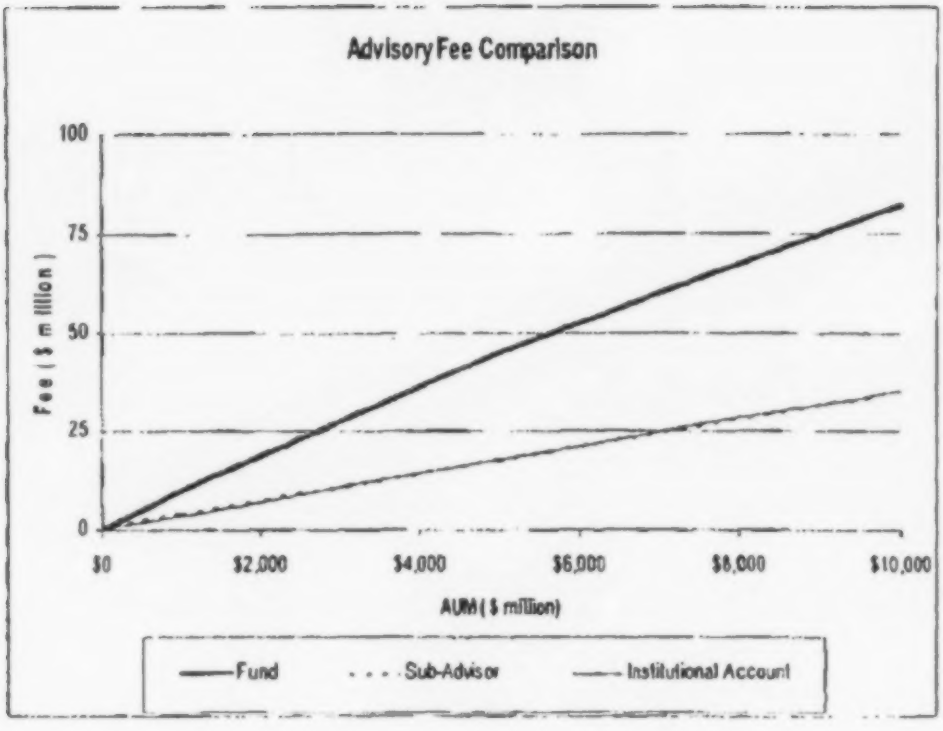
[7] The fees for the sub-advised and institutional accounts are represented as dotted lines for assets over $1 billion because the existing fee schedules do not yet contemplate assets at these levels.



The preceding analysis illustrates the relationship between contractual fees charged and assets under management for Institutional Accounts and mutual fund accounts. The relationship between the associated costs incurred and assets under management is an important concept. If average costs decline as assets increase and associated fees do not reflect these declining average costs, then the economies of scale being realized accrue to the benefit of the advisor and are not being shared with the shareholders of the Funds.

* * * * *

Compensation Analysis

Many of the analysts and portfolio managers at HALP are partners who participate in a discretionary compensation pool that is directly related to the

gross revenues of HALP.[13] On occasion, new partners become eligible for inclusion in this pool. The compensation enjoyed by these partners is significantly different than the industry norms for individuals with the same job responsibilities. This compensation is reflected in the annual profitability analyses given to the Funds' trustees as an expense. This has the effect of lowering the net profits and profit margins reported to the trustees. While it is common for an investment professional's base salary and bonus to be included in fund expenses, it is my opinion that the nature and magnitude of payments made here should more accurately be described as profit.

Quite simply under the terms of the agreement between the partners of HALP and HALP's parent company, the parent receives 41% of the gross revenues;[14] the remainder, after HALP pays its operating and business expenses, is allocated among the partners, at their discretion, through the C and D Compensation pools.

A list of HALP partners that benefit from the C and D Compensation pools, along with the respective

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[13] The partners point out that legally they are not owners, but the fact that they have discretion on how the remaining revenues of HALP are divided provides them with the economic benefit of such and is certainly a by-product of their deal with HALP's parent company. This deal is the result of the original sale of HALP's predecessor by its partners (many of whom are current "partners" at HALP) to HALP's current parent's predecessor. There is no doubt that this is what was referred to by John Raitt, the CEO, in his deposition by saying "there may be some ownership-type aspects to being a partner of the firm, and we recognize that." Deposition of John Raitt, p. 201; see also Deposition of William Nygren, pp. 148-49.

[14] This figure is subject to slight adjustments.

amounts of payments to them, is included in Exhibit 5. Summarized below are the annual amounts of these payments made to the partners.[15]

	C	D	Total
1996	$ 8,987,380	$24,897,073	$33,884,453
1997	$16,776,956	$39,892,007	$56,668,963
1998	$19,503,634	$51,963,497	$72,117,131
1999	$14,428,300	$41,182,711	$55.611,012
2000	$11,332,598	$24,307,084	$37,566,923
2001	$17,318,970	$32,019,671	$49,338,641
2002	$27,232,946	$43,601,634	$70,834,580
2003	$15,872,146	$61,630,941	$77,503,087

In 2003 alone, the individual payments ranged from $1.8 million to $14.1 million. In 2004, the upper end of the range topped $20 million.[16]

There are several surveys performed in the industry that give some indication of the range of compensation for these positions. One such survey is done by the Association for Investment Management and Research (AIMR).[17] Notably, when HALP requested information regarding industry compensation from Lipper, Lipper suggested that HALP seek out the AIMR compensation survey.[18]

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[15] HA-N000000041

[16] Deposition of William Nygren, p. 58; HA0141836.

[17] Now called the CFA Institute.

[18] HA 0009630

Based on the 2001 AIMR survey,[19] the median compensation is $793K for Portfolio managers and $330K for Equity Analysts.[20] The total compensation listed includes, salary, bonus and any non-cash compensation. These values represent fair compensation for the respective positions. The survey also identifies an extreme measure of compensation, the 90th percentile, which while obviously higher does not represent a reasonable estimate (and is still well less than half the compensation received by the partners of HALP). It is most likely that professionals with special profit sharing arrangements will show up at these ranges. The excess compensation received by the HALP employees listed above must be considered as profits paid to the partners of HALP. While higher than average compensation might be necessary to keep well-performing professionals, the values listed in Exhibit 5 certainly go beyond that.

HALP Economies of Scale

The standard methodology used to illustrate economies of scale is to examine the relationship between the advisory costs and assets under management. One of the trustees for the Oakmark mutual funds attempted such an analysis. As he pointed out:

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[19] AIMR conducts its survey biannually. In its most recent survey in 2005, AIMR reported that compensation levels have continued to show increases, but still remain below 2001 highs. See: http://www.cfainstitute.org/pressrom/05releases/2005050601.html. Accordingly, the 2001 survey provides the highest indication of industry compensation.

[20] The survey provides a breakdown of each position by several factors. The numbers identified are for investment professionals in large mutual fund complexes with the most seniority. The median listed in the survey for a CEO was $1.5 million, though there was only 1 respondent.

"In our case, as the individual funds grow, we should experience expense economies of scale and these economies should accrue to the benefit of our shareholders."[21]

For purposes of my analysis, the cost for managing each individual fund was determined by subtracting the amount of the Discretionary Compensation line item from the Subsidiary Level Expenses. This provides as true an estimate as possible of expenses from the data provided to the board and is consistent with how the board attempted to determine this relationship as well.[22] It appears that at some point at least one board member was under this same assumption that the compensation levels were high enough that they might not be considered a true expense of the operations. Any argument that the levels of compensation paid to the partners at HALP are a proper and necessary expense is unavailing. Certainly the advisor did not have to pay $77 million in discretionary compensation in 2003, nor did it have to pay Mr. Nygren $22 million in 2004.[23] They may choose to. They may be able to based on the fee schedules employed. But based on AIMR, these levels are not necessary to remain competitive within the industry.

Ironically, while the advisor provided the board with aggregate compensation, individual portfolio manager compensation was not disclosed.[24]

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[21] Notes of Michael Friduss. HA 0009236

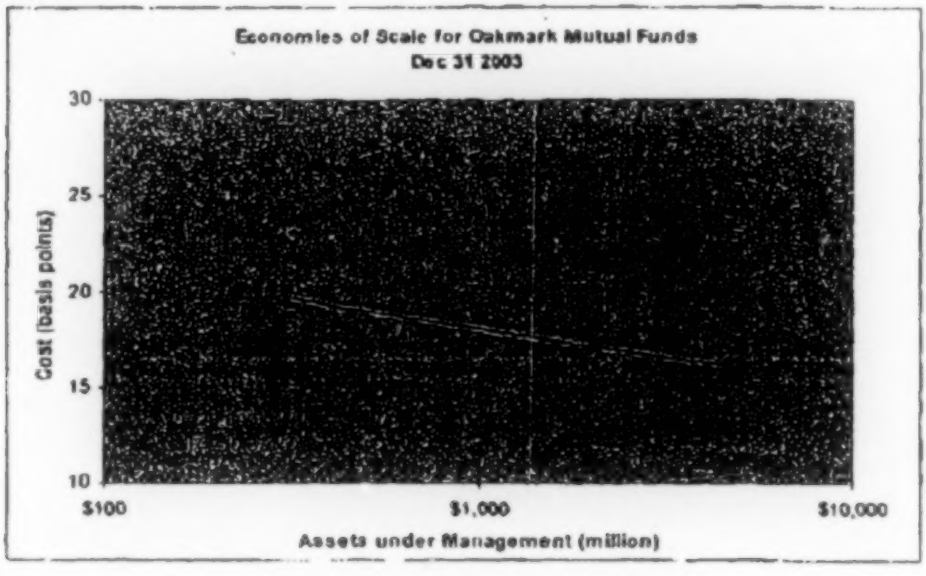
[22] Id.

[23] HA 0141836, 2004 W-2.

[24] Deposition of John Raitt, p. 210

The following data is from the defendants' report entitled "Adviser's Profitability Analysis,"[25] and my analysis closely mirrors that which was attempted by the board.[26] In summary the costs for the investment advisory function are illustrated below:

Chart 7



A linear regression illustrates the relationship as follows:[27]

Log (cost) = 3.39 - .07 Log (assets)

In reality the decline in cost given asset levels is probably steeper than this regression would indicate. Most of the actual line items for expenses are simply allocated pro-rata to each fund based on their respective revenue level. This places a greater percentage

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[25] HA 0000458

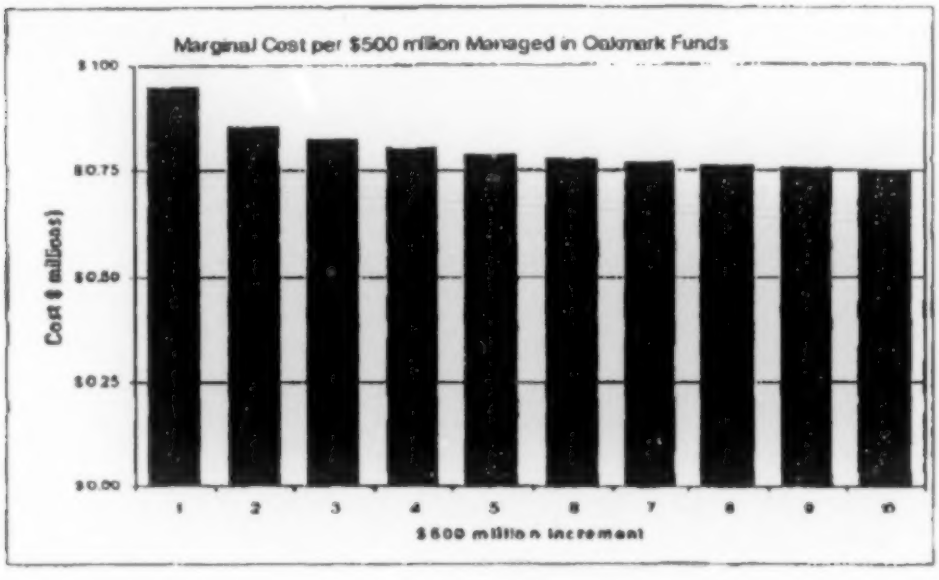
[26] HA 0009236-45

[27] The constant term is significant at the 99th percentile, while the slope is only significant at the 90th percentile.

of expenses with the higher revenue funds as well as a lower percentage of expenses with the lower revenue funds.[28] This methodology tends to mask the economies of scale inherent in the business and actually mutes the quality of the statistical relationship identified above.

Based on the regression above we can impute the marginal cost to manage incrementally more assets. The chart below illustrates this marginal cost for managing additional assets within the funds.[29]

Chart 8



While the cost to manage the first $500 million dollars is $950 thousand, the second $500 million costs only $860 thousand, while the tenth costs only $750 thousand. Each successive increment costs less and

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[28] In general, revenues tend to track assets and would be exactly proportionate but for differing fee schedules across funds.

[29] Costs are based on the regression line identified above.

less.[30] If we interpret a 'unit' to be providing advisory services to the next $500 million of assets under management, we see from the above chart that the cost of producing each unit declines as assets grow. This is exactly what is meant by economies-of-scale.

Oakmark Mutual Funds vs Individually Managed Accounts

As stated above, HALP sells its services to two sets of clients: Oakmark mutual funds and individually managed Institutional Accounts. The advisory services provided to the Oakmark mutual funds, including the Funds at issue in this case, by HALP are essentially identical to those advisory services provided by HALP to its Institutional Accounts. As a result, they entail virtually the same costs. In competitive markets, similar products should sell for similar prices. This is not the case, however, at HALP. Advisory fees charged by HALP to the Funds at issue in this case are substantially greater than those charged by HALP to its Institutional Accounts.

I reviewed HALP's responses to Requests for Proposal (RFPs) and questionnaires through which HALP offers to provide advisory services to institutions and sub-advised mutual funds. The documents reviewed indicate that investment management for HALP is the result of a team process, which includes portfolio managers, analysts and technologists. The research efforts, which are a significant component of the investment process, are performed within a single group that serves the needs of all the portfolio managers, both institutional as well as mutual funds,[31]

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[30] These values are based on the smoothed regression line identified in Chart 7.

[31] Deposition of Henry Berghoef, p. 36, 82.

and the same people who manage institutional and sub-advisory accounts contribute to the management of the Oakmark mutual funds, including the Funds at issue.[32]

In a questionnaire to a consultant, when asked what products HALP could offer someone interested in a Large Cap portfolio, HALP responds by proposing either the Oakmark Fund or a separate account, identifying the only difference between them as being the account minimum size.[33] For a concentrated mandate, they again are indifferent between a separate account and the Oakmark Select fund.

Pricing Comparison for Oakmark Mutual Funds and Institutional Accounts

The fee schedules associated with asset management services for the Oakmark mutual funds and the Institutional Accounts are vastly different. For the Institutional Accounts, fees are much lower than the fees charged to the Oakmark mutual funds (including the Funds at issue in this case) for the same services.

There is no compelling reason why the board of a mutual fund would overpay for such services unless it was either controlled by the advisor or did not receive complete information.

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[32] See for example HA_S000127575-77 for a discussion of the stock selection group and the concentrated portfolio strategy committee.

[33] HA_S000127705

As part of their justification, the advisor informs the board that:

"*Management of a mutual fund involves far more comprehensive and substantive duties than the management of sub-advised funds or separate accounts.*"[34]

This is simply not true. The advisory services are virtually identical between these two types of accounts, and has been acknowledged as such by the advisor.[35]

The advisor then goes on to "*facilitate an 'apples to apples' comparison*" by comparing the "effective management fee paid by shareholders (of sub-advised funds)" with the management fee of the subject fund. This comparison indicates that this effective fee is in line with the fee charged to the fund itself. While this is true, it is also irrelevant. The cost structure of the distributor and servicer of those assets, and what they choose to charge for their service, has no basis on the merit of the fee that HALP charges for its service.

This same opinion was voiced by the Director of Client Relations, Michael Neary, who recognized that HALP's defense regarding the fee discrepancy "is weak but not zero" and then went on to say:

"*Adding back the sponsor's management fee brings our sub-advised portfolios to fee levels that are comparable to Oakmark.*"

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[34] HA 0000437

[35] Deposition of Clyde McGregor, p. 37

Yet both he and Bill Nygren voiced concern over certain institutional accounts with large fee gaps and nearly identical mandates.[36]

Comparison of Fee Schedules for HALP's Various Clients

Each of the Funds is discussed separately below in terms of their investment style.

Large Cap Equity

The Oakmark fund is managed in the large cap equity style and has the following fee schedule:

1.00% on the first $2 billion
0.90% on the next $1 billion
0.80% on the next $2 billion
0.75% on assets over $5 billion.[37]

Sub-Advised accounts follow a much lower fee schedule. For example, HALP charges MetLife, the largest such account, the following fee schedule:

0.45% on the first $100 million
0.40% on the next $400 million
0.35% on assets over $500 million.[38]

For separately managed institutional accounts, the fee schedule declines to the same 35 basis point level, yet achieves that level much sooner. For example, HALP discloses to the board a large cap client, Client #2, with the following schedule:

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[36] HA_E0023970 and HA_E0237411

[37] HA 0000438

[38] Id.

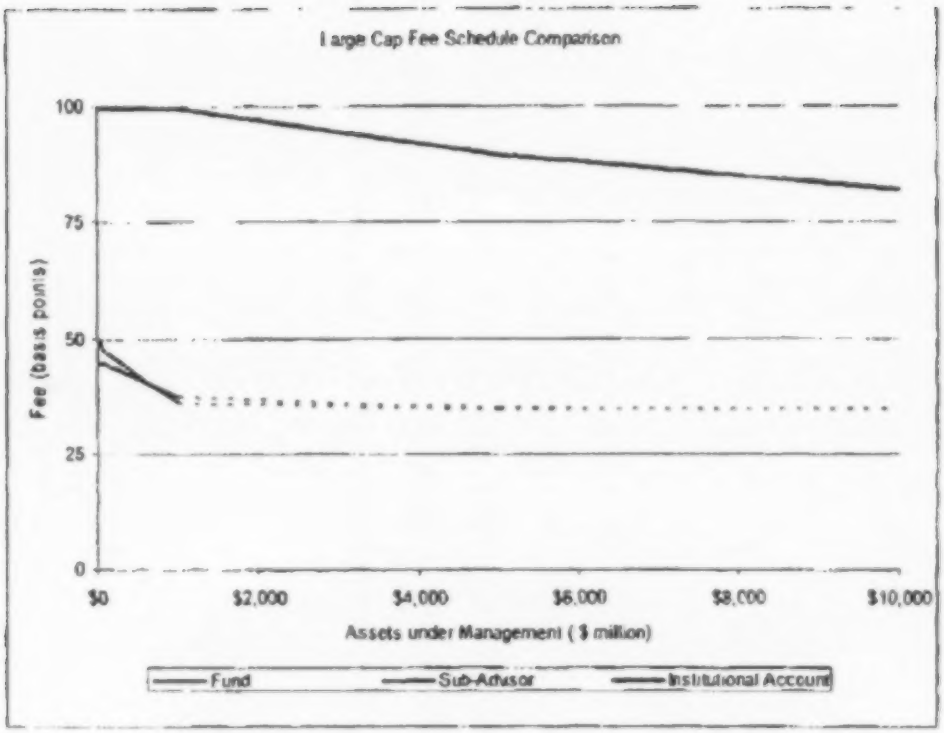
0.50% on the first $50 million
0.45% on the next $50 million
0.40% on the next $50 million
0.35% on assets over $150 million.[39]

The chart below summarizes the various fee schedules discussed above for Large Cap Equity products.

	Mutual Fund	Sub-Advised	Institutional
$100 million	100.0	45	48
$ 1 Billion	100.0	38	37
$10 Billion	83.0	35	35

Repeated below is a comparison of the fee schedules for the large cap equity funds to the institutional account schedule.

[39] I believe this account is HCA Master Retirement Trust (0688), HA0135013X-27X. Another account, HCI Incorporated (1092), is listed with the same schedule.



The difference between the fee schedule for the Institutional Accounts and the fee schedule applicable to the Funds represents the difference that negotiation plays in the pricing of accounts in the institutional marketplace, where the degree of arms-length bargaining apparently drives fees down considerably. The fees charged to the Funds, on the other hand, are considerably higher. Not only is the fee schedule lower in absolute terms for the Institutional Accounts, but breakpoints are incurred much earlier in the growth of assets.

Balanced

The Oakmark Equity & Income fund is managed in the balanced style and has the following fee schedule:

0.75% on the first $5 billion
0.70% on the next $2.5 billion
0.675% on the next $2.5 billion
0.65% on assets over $10 billion.[40]

There are no sub-advised accounts in this style, yet the institutional accounts have a much lower fee schedule. For example, HALP charges "Client C" the following fee schedule:

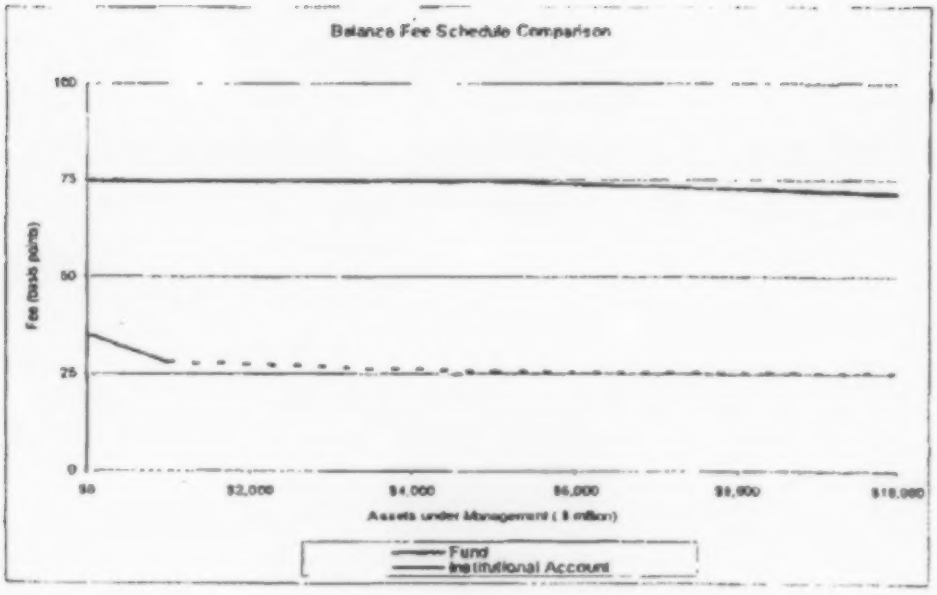
0.35% on the first $100 million
0.30% on the next $400 million
0.25% on assets over $500 million.[41]

The chart and graph below summarizes the various fee schedules discussed above for the balanced products.

	Mutual Fund	Sub-Advised	Institutional
$100 million	75	na	35
$ 1 Billion	75	na	28
$10 Billion	72	na	25

[40] HA 0000440

[41] Accounts 2657 and 2658, HA0135013X-27X. The accounts for Client C are set up as two separate accounts, one equity the other fixed income, with identical fee schedules, HA 0135020X.



Global

The Oakmark Global fund is managed in the global style and has the following fee schedule:

1.00% on the first $2 billion
0.95% on the next $2 billion
0.90% on assets over $4 billion.[42]

Sub-Advised accounts follow a much lower fee schedule. For example, HALP charges the Asahi Global Fund a flat 60 basis points for all asset levels.

For separately managed institutional accounts, the fee schedule declines even more dramatically. For example, HALP charges "Client A" the following fee schedule:

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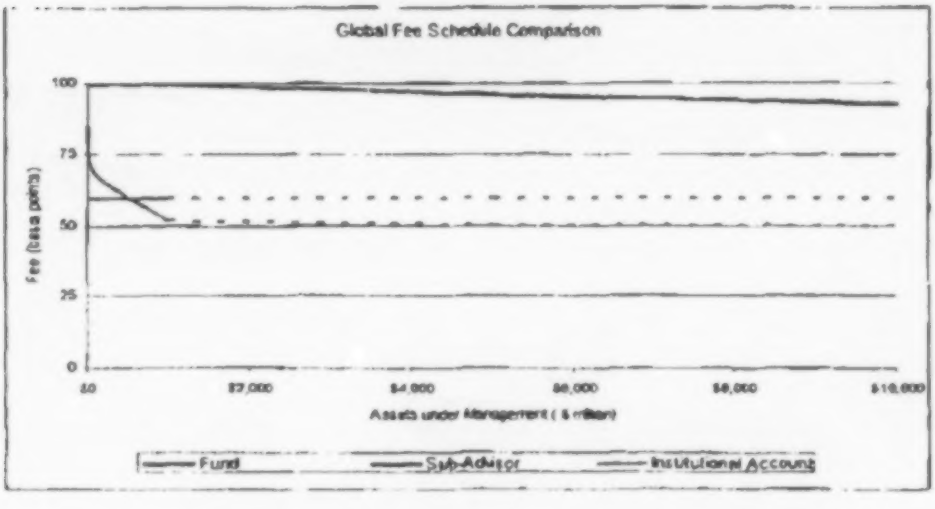
[42] HA 0000442.

0.85% on the first $25 million
0.70% on the next $25 million
0.60% on the next $50 million
0.50% on assets over $100 million.[43]

The chart below summarizes the various fee schedules discussed above for global products.

	Mutual Fund	Sub-Advised	Institutional
$100 million	100.0	60	69
$ 1 Billion	100.0	60	52
$10 Billion	93.0	60	50



Marginal Cost of Advisory Services at HALP

Chart 9 compares the marginal cost of managing an additional $500 million in assets to the marginal revenue for HALP using, for example, the mutual fund fee schedule discussed above for a large cap equity fund.

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[43] Accounts 3176 and 3177, HA0135013X-27X

Chart 9

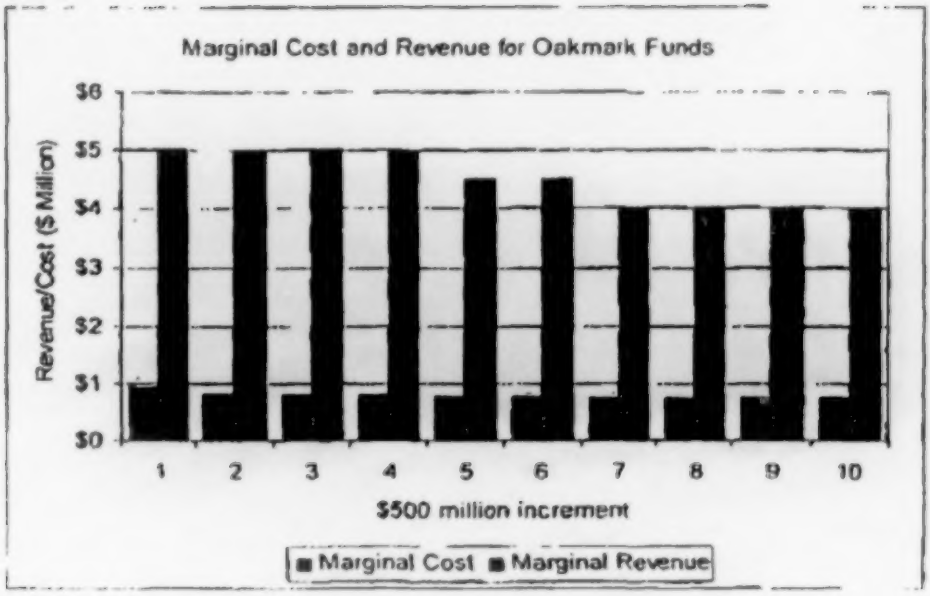

Chart 9 clearly illustrates that little of the decrease in marginal cost resulting from an increase in assets in the Funds is being shared with the investors in the Funds. This means that HALP is retaining for itself as additional profits the cost economies associated with increased assets under management, rather than sharing them with the shareholders of the Funds.

For example, while the cost of managing the fourth $500 million increment declines from the cost of managing the first, from $950 thousand to $810 thousand, or a decline of 15%, the fee charged for managing that money remains at $5 million. Marginal profit has increased from $4.05 million, or 81% of revenue, to $4.19 million which is now 84% of revenue. HALP is realizing an increase in profitability even before the first breakpoint. Further breakpoints do very little to change the marginal profit which remains over 80%.

Fund Profitability

Mutual fund directors are required to discharge their duties on a fund-by-fund basis, even when they simultaneously serve on multiple fund boards, as is the case with the Oakmark mutual funds. Specifically, advisory contracts should be considered and approved on a fund-by-fund basis, rather than on a complex-wide basis.[44]

The actual allocation of expenses to each fund makes a fund-by-fund analysis of profitability impossible. Most of the actual line items for expenses are simply allocated pro-rata to each fund based on its respective revenue level. In this manner, the profit margins are all tightly clustered around the margins for the entire complex, with no regard for the specifics of each fund.

For example, if a fund had significantly less assets than the average fund in the complex, its revenue would similarly be much lower. Allocating expenses to funds pro-rata would have the effect of allocating too few expenses to the smaller fund than the real and actual fixed costs of managing the fund. Yet the smaller fund would have a profit margin comparable to the margin of the larger funds. This approach overstates the profitability and margins of lower asset funds and lowers the profitability of higher asset funds. An accurate representation of fund profitability is not being provided for any of the funds.

Furthermore, the discretionary compensation, referred to above, is not an expense, but rather payments made to partners and, as such, should more right-

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[44] Business Lawyer, November, 1996, "Fund Director's Guidebook," American Bar Association.

fully be viewed as an investment return. Simply speaking, it is profit. When this is taken into account, the pre-marketing and parent level profit margin indicated would be 91%, not the 54% which was reported to the board.[45]

Soft Dollar Commissions at HALP Associates

The practice of soft dollar commissions is reasonably common within parts of the investment management community. Typically, this is accomplished when an advisor establishes a relationship with a broker where for a slightly higher commission, the broker will take on the responsibility of making certain payments for services provided to the advisor through various vendors under safe harbor provisions. These types of services are usually research, data and systems related. Examples of the types of products that could be paid for through 'soft-dollars' include Compustat, Bloomberg or Reuters.

For example, if an advisor negotiates commissions of 2 1/2 cents per share, they may actually pay 4 cents a share for a "soft-dollar" trade. The additional 1 1/2 cents paid is then forwarded to the specific vendors on behalf of the investment advisor. The advisor would be obligated to pay "hard dollars" for these services if the soft-dollar commissions generated are inadequate. Hard dollars are typically direct payments from the investment advisor to the vendors and would ultimately be paid from advisory revenues.

When the issue of soft dollars came up, the advisor informed the board that eliminating soft dollars would not provide any tangible benefit to the share-

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[45] HA 0000458-59

holders.[46] While Mr. Berghoef indicated HALP is phasing out soft dollars,[47] Mr. Raitt claims it is still practiced.[48]

The consequences of this approach are, first, that institutional accounts are deriving fall out benefits from the mutual funds' trades and, second, that the mutual fund is paying for services that institutional accounts are not willing to pay for. This has the effect of increasing the actual expenses paid by the mutual fund shareholders as the higher trading costs lead directly to lower investment returns.

Comparison of Mutual Fund Performance with Individually Managed Accounts

I have compared the performance of the Funds with their institutional counterparts.[49] The institutional data used for comparative purposes is the composite data that HALP produces as part of the monitoring and marketing of its institutional capabilities.

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[46] HA 0009246

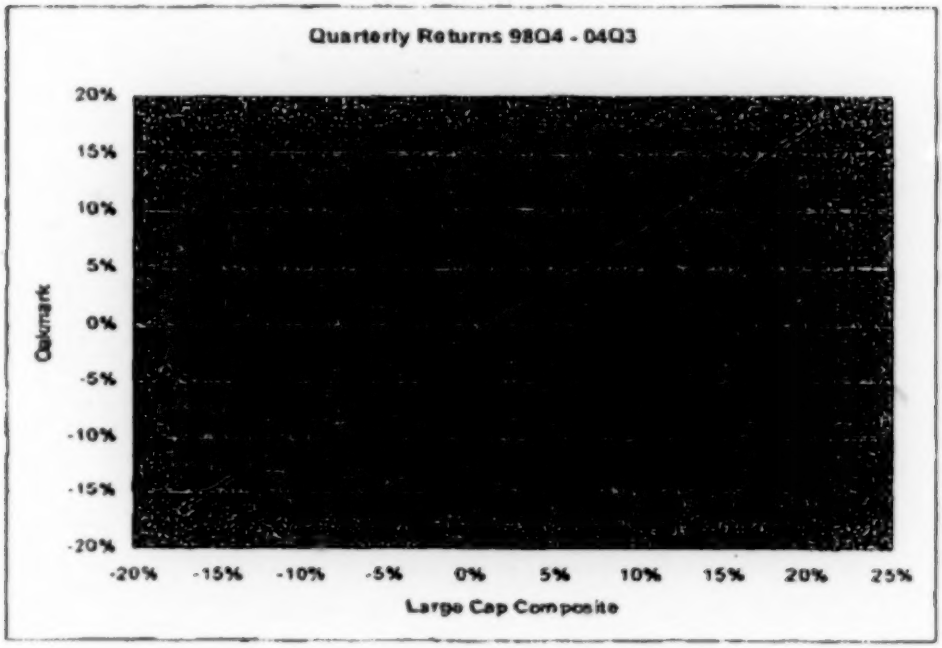
[47] Deposition of Henry Berghoef, p. 88

[48] Deposition of John Raitt, p. 268-9

[49] HA 0055405

Oakmark

Illustrated below are the quarterly returns for the fund as well as the composite.[50]



Notice that the intercept term, -1.01%, is negative indicating that the performance of the fund is less than that of the composite accounts. The t-stat for this term is -2.2, which is statistically significant.

Investors in the mutual fund have received less return from their investments than institutional investors. Over the last five years, the fund has had an annualized return of 6.40% as compared to 10.69% for the composite.

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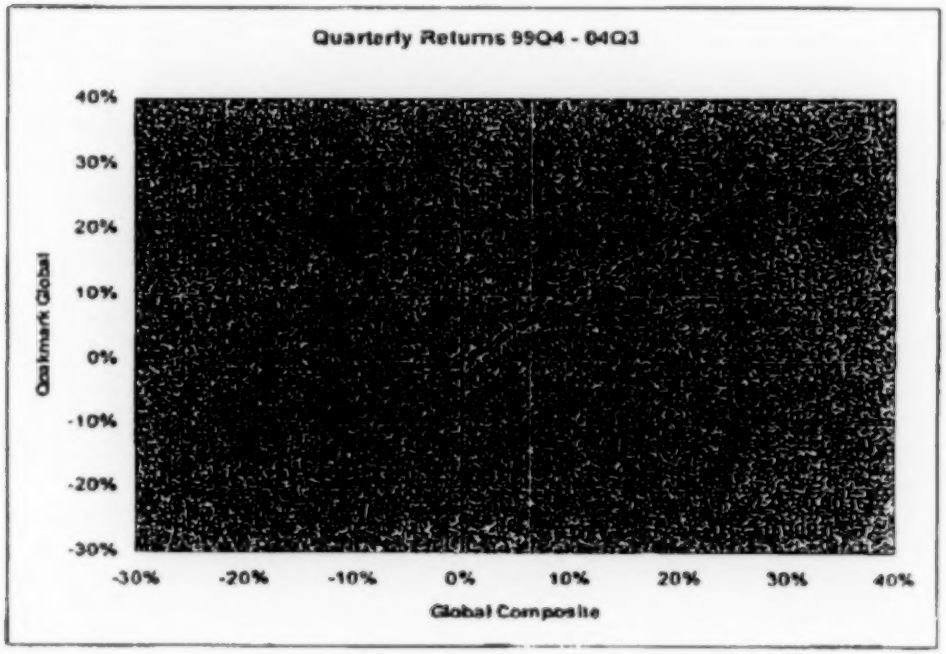
[50] HA 0055452, HA 0055462

Global

The Global mutual fund has also under-performed the composite.[51]



Note here that the slope of the regression as well as the R-squared are virtually 1.0 because the fund makes up a significant component of, or is identically managed like, the composite. The constant term here, -0.36%, per quarter has a t-stat of -6.2, which is extremely significant. The fund here is under-performing the composite by a very consistent 36 basis points per quarter. Over the last five years, the fund has returned 17.7% as compared to 19.4% for the composite.

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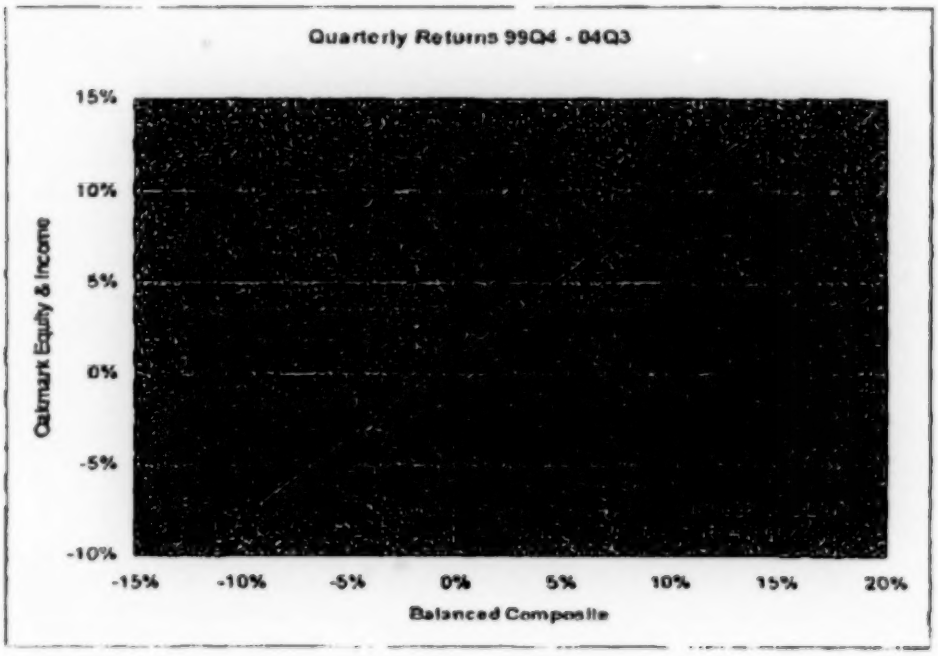
[51] HA 0055536, HA 0055563



Taken over this time period[52], the intercept term is a positive 77 basis points per quarter with a t-stat of 1.7. Over the entire time period, the fund has returned 13.1% versus 11.1%.[53] As the chart illustrates the majority of that out performance comes from just two quarters, rather than from any consistency of the process.[54]

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[52] Though the data for these two investments goes back much further, I have only presented results for the last 5 years, to be consistent with the other funds and further to focus on the relevant history of the fund.

[53] HA 0055442, HA 0055490

[54] The information ratio of the fund relative to the composite is only .5, so while the fund has fared better, the out performance is far from statistically significant. (The information ratio is defined as the relative performance of two investments divided by the standard deviation or volatility of that performance, and is similar to the Sharpe Ratio.)

Conclusion

The opinions contained herein are based on the facts presented to me to date. I reserve the right to supplement these opinions, if appropriate, as additional information is presented to me and I may prepare additional charts, graphs and demonstratives for trial. In addition, I may have opinions to offer in reply to testimony presented by defendants' experts.

Respectfully Submitted,

/s/ STEVE POMERANTZ

Steve Pomerantz, Ph. D.

* * * * *

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION
Case No. 1:04-cv-08305 CPK

JERRY N. JONES, et al.,
Plaintiffs,

vs.

HARRIS ASSOCIATES L.P.,
Defendant.

SEPTEMBER 5, 2006

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Rebuttal Expert Report of Steve Pomerantz

* * * * *

This report is offered pursuant to Federal Rule of Civil Procedure 26(a)(2) and is authored by Dr. Steven Pomerantz, president of Steve Pomerantz LLC, an economic and financial consulting firm located in Princeton, New Jersey. I have been designated as an expert by Plaintiffs in the above-referenced action. My qualifications, background, expertise, and publications, as well as information regarding my compensation in this matter, are discussed in my Expert

Report dated January 30, 2006 ("Expert Report"), which is incorporated by reference, and in my CV which is attached as Exhibit 1.

Reports Reviewed

I have reviewed the report of the Defendants' expert, Dr. Ajay Khorana ("Khorana"), in this case, as well as his deposition. Additional information that I rely upon for purposes of my opinions are contained in the footnotes to this report. I intend to offer the following opinions in the nature of rebuttal.

On the Cost of Additional Services

In his report, Khorana[1] states that the Oakmark mutual funds (the "Funds") are offered additional services by Harris that are not provided to the institutional accounts,[2] and that I ignore this fact in my analysis. Contrary to Khorana's assertion that I merely assumed the equivalence of service, my opinion is based on both my experience as well as a basic analysis of defendant's own data. The cost of any additional services provided to the Funds is truly de minimis. In fact an analysis of defendants' experts' own reports, along with Harris' own data, illustrates that the costs associated with the services provided to the institutional business actually exceed the costs of the services provided to the Funds.

In support of the defendant's position that the Funds require additional services, Khorana cites such responsibilities as providing officers to the board, oversight of third-party providers, and regulatory compli-

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[1] Expert report of Khorana [43 – 49].

[2] I use the term "institutional accounts" or "institutional business" to refer to Harris' non-Oakmark Fund accounts, including separate accounts and subadvisory accounts.

ance. As further support for the defendant's position, Thomas Blake in his expert report specifically identifies that there are seven members of the fund operations department dedicated to the Funds and nine administrative personnel partially dedicated to the Funds. The compensation required for these personnel is less than 1 basis point of the Funds' assets under management.

In reality, the cost of these services and indeed of all services provided to the Funds is quite small. Indeed when compared to the cost of providing services to the institutional accounts, the true cost differential is actually negative. In other words, the cost of providing all services to the Funds, not just those identified in Blake or Khorana, is less than the cost of providing all the services required by the institutional business. In order for the additional services provided to the Funds to be a realistic explanation for higher fees, it is at least necessary for the costs to manage the Funds to be higher, not lower, than the costs of managing the institutional business.

I have broken down Harris' costs of providing services into two components, overhead and personnel. Based on Defendant's estimate of time spent by employees on the Funds[3], there are approximately 50 full time equivalents ("FTE") dedicated to the Funds. This includes not just the personnel dedicated to the Funds identified by Blake, but also the portions of all employees in all operating groups, including Legal, Research, Portfolio Management, Corporate Accounting, Human Resources, etc. These 50 FTE constitute approximately 28% of the 178 total headcount at Harris.

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[3] HA0089774.

The 2003 Income Statement[4] identifies approximately $9.2 million in overhead related expenses which are listed in Exhibit 2. Of this amount, 28%, or roughly $2.5 million, I have allocated to the Funds. Based on assets of $22.6 billion, the cost of overhead for the Funds is thus 1.1 basis points. The overhead allocated to the institutional accounts amounts to 2.8 basis points of those assets.

In addition to these overhead costs, the actual compensation for each employee can be allocated between the Funds and institutional business based on the time estimates for each employees.[5] The total compensation reported is $28.6 million.[6] Based on the time estimates, $9.8 million is dedicated to the Funds and $18.8 million to the institutional business. The Fund portion is equivalent to 4.3 basis points, while the portion allocated to the institutional accounts is 8.0 basis points.

Again we see that the costs of running the institutional business exceed the costs of running the Funds. Adding the two components discussed above (overhead and personnel), illustrates that the total cost for maintaining the institutional business is 10.8 basis points, while the Funds only cost 5.4.

Left out of the analysis above is the Discretionary Compensation amounts which I have previously opined to be profit, not an expense. Even if the value is treated as an expense, for the purposes of the above analysis, it can be divided between the Funds and the institutional accounts based on the time estimates for each partner. This results in an allocation of $38.8 million to the Funds, for a total cost of

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[4] HA0009830.

[5] HA0089774.

[6] Compensation data is taken from HA_N00000331.

22.6 basis points, and $33.8 million to the institutional accounts, for a total of 25.1 basis points.

The chart below compares the costs for the Funds and the institutional business:

		Mutual Funds	Institutional Accounts
Assets Under Management		$22.6 billion	$23.6 billion
Overhead		0.011%	0.028%
Compensation		0.043%	0.080%
	Sub-Total	0.054%	0.108%
Discretionary Compensation		0.172%	0.143%
	Total	0.226%	0.251%

So while the advisor certainly bears a cost to provide shareholders with Fund services, this cost is actually far less than the costs they assume to provide services to their institutional accounts. The notion that Fund shareholders should pay more than institutional investors does not seem justified based on the actual costs assumed and reported by the defendant.

On Economies of Scale at the Fund Level and the Effects of Discretionary Compensation on Fund Margin

The allocation of C and D plan compensation to the Funds based on revenue is inappropriate. To the extent that line items for expenses are simply allocated proportionally to each Fund based on revenue levels, the underlying economies of scale are being masked.[7]

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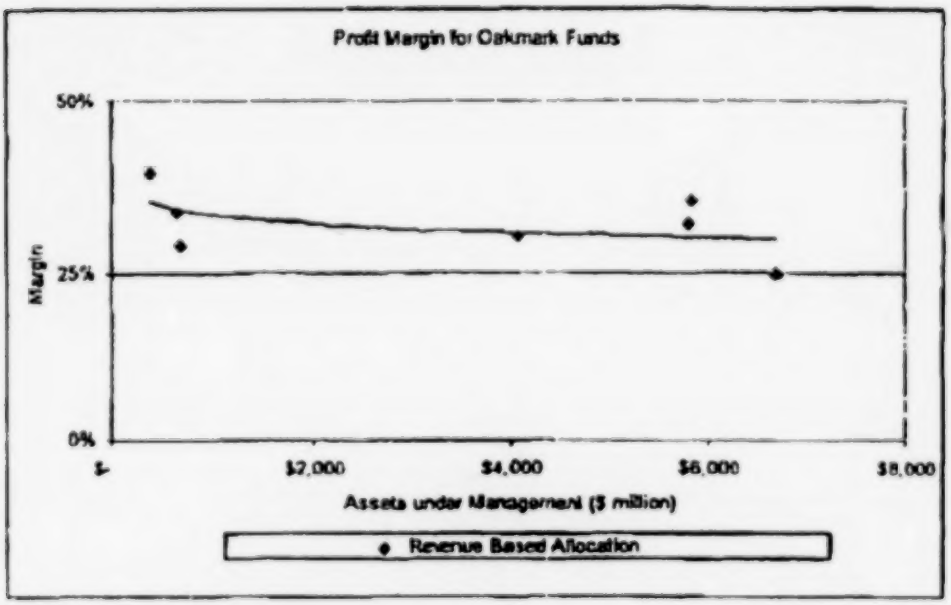
[7] I have previously argued that these payments represent profits, not expenses, an opinion which I still hold. This section is merely to illustrate the effects of reporting these expenses to the board in a more appropriate manner.

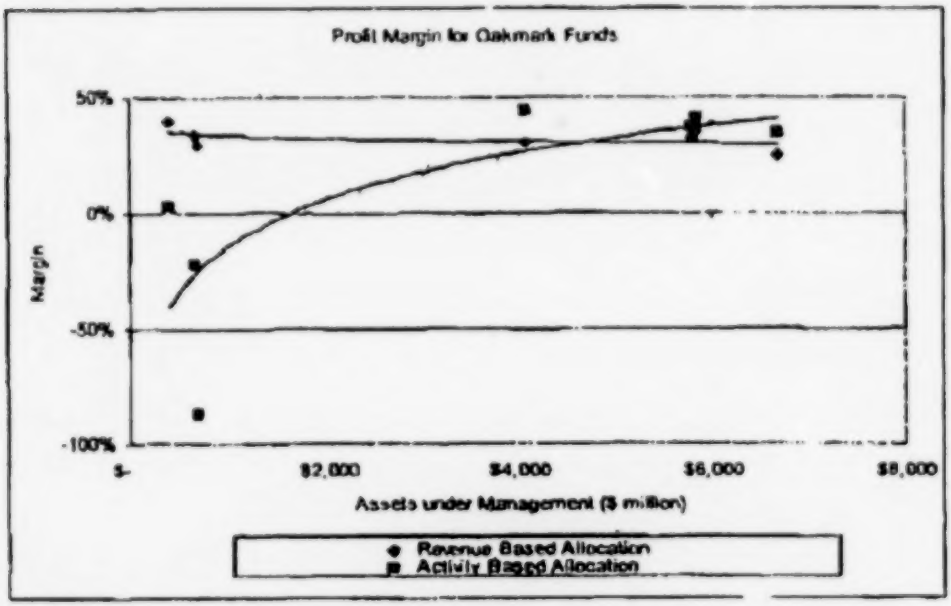
This allocation places a greater percentage of expenses with the higher revenue, or asset, Funds as well as a lower percentage of expenses with the lower revenue, or asset, Funds. This methodology tends to mask the economies of scale inherent in the business and forces investors in high revenue Funds to subsidize lower revenue Funds without offering them any benefit.

A more realistic approach is to allocate costs to the actual Funds using them. In the case of Oakmark, most of the C and D plan participants are identified with specific Funds.[8] As the graph below illustrates, profit margins under the existing allocation method tend to cluster in a narrow band of values. In fact there is a slight decrease in margin as assets rise, contrary to the intuition of investment management economies of scale.



[8] For the analysis that follows, I have assigned portfolio managers to their specific Funds and analysts to all Funds of their asset class. Administrative participants are allocated to each Fund.

Under an alternative allocation of these expenses, one based on aligning the recipients with their respective Funds, we see the more natural relationship between assets and operating margin. As expected, margins are negative for lower assets Funds and then rise to some limiting value.



On Economies of Scale at the Complex Level

In addition to an analysis of economies of scale at the fund level, which is masked by allocating expenses pro-rata to revenue, Khorana performs an analysis at the complex level. Here he claims that Harris is operating close to efficiency by illustrating that the scale measure of costs is close to, or at least statistically equal to, 1.0.

In his Exhibit 8, three models are shown that identify a scale measures for Harris as a value between .86 and .94.

The analysis shown is incorrect as it is based on erroneous data and methodologies and consequently produces meaningless and false results.

At the most fundamental level it is meaningless to infer the state of economies of scale at Harris by examining all industry data. Each complex has its own cost structure that will produce different results. These models draw a conclusion about Harris by utilizing exogenous data. I will calibrate these models using Harris' own data below. It is ironic that all the data for Harris is not even included in the data sample. While the data for various fund complexes is provided through 2004, the data for Harris terminates in 2003.

In addition the data relied upon suffers from asynchronous timing and produces meaningless values. For example, there is a variable in Model 3 called "Percent of Total Assets in Mutual Funds", which should be a number between 0% and 100%. In the dataset used by Khorana, of the 184 observations used, 39 of them exceed 100%. These values are simply wrong, and should not have been used. The rest of the observations, though not greater than one, are also incorrect as they suffer from the same source problems. Their inclusion invalidates any results derived from them. Many of the other datapoints may suffer from asynchronous timing as well. An additional methodological error is revealed by examining the R-squared for each of Khorana's models. As the number of variables is increased, the quality of the regression should improve. In comparing Model 3 to Model 2, which uses the same dataset, the reported R-Squared actually declines from .967 to .864, which is a virtual mathematical impossibility.

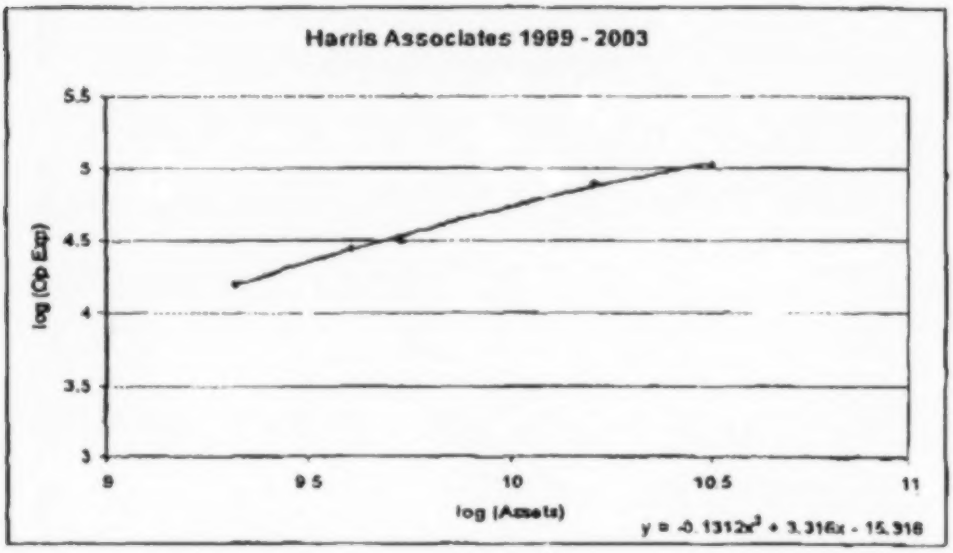
In fact, a recalculation of these models produces more intuitive results. The results of these regressions appear in Exhibit 3, but the R-squared and scale measures for each model based on the 2003 asset levels at Harris are shown in the table below.

	Model 1	Model 2	Model 3
R-Squared	.926	.972	.984
Harris Scale	.810	.938	.962

However, as stated above, using cost data of other fund complexes in evaluating economies of scale at Harris leads to meaningless and false results. Simply put, the scale measure quantifies the expected growth in expenses given a change in assets. For example, if assets increase by 20%, and costs increase by 10%, the scale measure is 0.5. In the data provided for Harris, we can compare the change in assets and operating expenses from 1999 until 2003. Over this period, assets grew from $14.8 billion to $36.5 billion, for an increase of 146%. Over the same period, operating expenses grew from $85.1 million to $153.5 million, for an increase of 80%. Intuitively, we therefore expect the scale measure to be approximately 0.55,[9] far different than that calculated by Khorana or recalculated above. The cause of the discrepancy between the expected value and the values above is that those models were calibrated using data irrelevant to Harris. Just as they overstate the true scale for Harris, they no doubt understate the scale for other fund companies.

[9] 80 divided by 146.

The Harris data actually provided allows for a recalibration of Model 1 using only Harris' data,[10] from which we see that though operating expenses are increasing as assets increase, the rate of increase is actually declining, indicating that Harris experiences greater economies of scale as assets grow.



This increase in efficiency is calibrated by the scale measure which is illustrated below[11] and is compared with the results Khorana obtained by incorporating exogenous and incorrect data.

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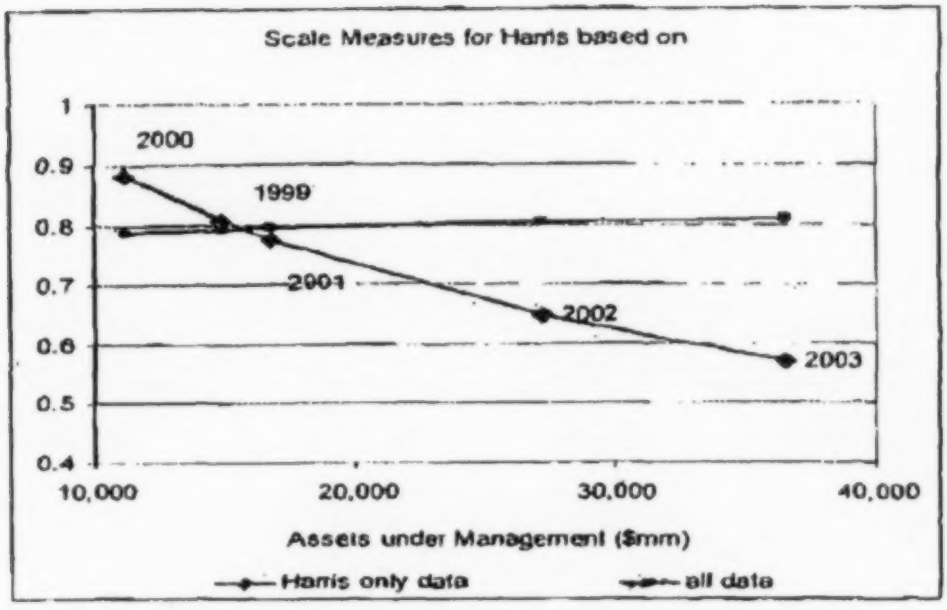
[10] There is a comparable difference between results for Models 2 as well, while the data does not support a recalibration of Model 3.

[11] See Exhibit 4 for the regression results for this analysis.



Note that while Khorana's analysis, which uses exogenous data, produces a scale measure of 0.81, an analysis using only Harris data produces a theoretical value of 0.57, which is very close to what was calculated above using the actual change in assets and expenses.

Khorana tries to support the incorrect and misleadingly high scale measure by referencing the fact that several of the Oakmark Funds are closed to new investors. While several of the Oakmark Funds are indeed closed, they have been closed for some time and have experienced significant growth in assets since that time. For example, the International Small Cap Fund has been closed since May of 2002, but assets have nearly tripled since that time.[12] Contrary to what Khorana suggests, Harris' profitability does not seem to have suffered as a result. Profit margins

[12] At the end of 2002, assets under management were $368 million, and at the end of 2005, assets were $1.042 billion.

for this Fund alone rose from 25% in 2002 to 34% in 2003,[13] hardly what one would expect were a fund suffering from diseconomies of scale. In fact, the board repeatedly acknowledges that the closures of the Oakmark Funds were due to capacity constraints in the asset class and concern for hurting performance.[14] Economies of scale were not the issue, contrary to Khorana's assertion.

On the Comparison of Expense Ratios for Oakmark Funds

Khorana's analysis based on Exhibits 6A-C of his report is misleading as it illustrates the relative ranking of the expense ratios of the Oakmark Funds relative to the median expense ratios for their Morningstar objectives. This analysis ignores the relative level of assets for the Oakmark Funds relative to the size of the funds in the peer group. A comparison of expenses versus the asset weighted average produces a different picture of the relative expenses of the Oakmark Funds.

Fund	Morningstar Objective	AUM	TER	Mstar Objective Average (Eq wt)	Mstar Objective Average (Mkt wt)	Mstar Objective Median	Oakmark %ile
Oakmark Eq. & Inc I	Moderate Allocation	9,513	0.89	1.24	1.00	1.19	0.31
Oakmark Global I	World Stock	1,957	1.20	1.70	1.00	1.67	0.22
Oakmark I	Large Value	6,102	1.03	1.38	1.00	1.31	0.28

While the Oakmark expense ratios are below the Morningstar medians, they are actually much closer to the market weighted averages. In fact for two out

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[13] HA0000459-460. Profitability data for later years was not available.

[14] HA 0010818, HA 0009493

of three funds, the Oakmark expense ratio actually exceeds the weighted average.

* * * * *

Respectfully submitted,

/s/ STEVE POMERANTZ

Steve Pomerantz, Ph. D.

EXHIBIT B-1

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF HENRY BERGHOEF

August 30, 2005

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[35]

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Q. . . . The research that you do, who receives that research or who gets the benefit of that research?

MS. FELICELLO: Objection.

THE WITNESS: You mean who it's distributed to?

BY MR. BRICKMAN:

Q. Yes, sir.

A. It's distributed to all the portfolio managers and investment analysts in the firm, and there may periodically be other people within the firm who –

who see it. There are other people within the firm who see it. Typically these would be, for example, marketing people.

[36]

Q. When you say "portfolio managers," those are people who manage either the mutual funds or the private accounts or the institutional accounts; is that correct?

A. Correct.

Q. So that your research is distributed, I guess, to everybody who does any sort of investment at Harris Associates?

MS. FELICELLO: Objection.

THE WITNESS: All people involved in the investment process, all what we call investment professionals, have equal-opportunity access to the research.

BY MR. BRICKMAN:

Q. As far as you know, do they use your research, all these investment people or portfolio managers?

A. They're paying me a lot for it, so I trust that they're using it.

Q. Okay. And is that true for all the work that comes out of your department, the research department, all 16 of you in that group?

A. Yes.

Q. The work of all 16 of you goes to all [37] the investment managers, including portfolio managers of the mutual funds, the private accounts, the institutional accounts, high net worth, limited partnerships, et cetera?

A. It goes to all people with investment decision-making responsibilities within the firm.

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EXHIBIT B-2

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF MICHAEL J. FRIDUSS

September 1, 2005

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[182]

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BY MR. BRICKMAN:

Q. Mr. Friduss, we had mentioned earlier when we were talking about economies of scale the concept of breakpoints.

[183]

Do you recall that?

A. I've mentioned it a number of times myself, so . . .

Q. What do you understand is the reason breakpoints are put into play on fees being charged by Harris Associates to the Oakmark funds?

A. I think that our objective in – in using breakpoints is that as the funds start up and mature and grow, that there are some kinds of economies that are generated. And we want to accrue those as much as we can to the shareholders. And so as the funds grow, the incremental expense fee drops; and those are the breakpoints.

Q. Is it then your intention that those breakpoints are to capture the economies of scale being attained so that they are passed on to shareholders in some way?

A. Yeah. I mean, they are intended to capture some economies of scale that – that accrue to the shareholders.

Q. Okay. How –

A. We don't scientifically know exactly what we're doing when we put those breakpoints in, [184] but that's the intent.

Q. Okay. How do you figure out where to put them?

A. You know, there's no – we have never found a scientific way to do it. We – we look at it. We negotiate with – with Harris. We make a determination of where perhaps the independent trustees think they ought to be, and we look at where Harris thinks they ought to be; and, you know, we mutually agree to it. We've never found a scientific way to do it.

Q. What would indicate to you the breakpoints are set at too high a figure?

A. What do you mean by that?

Q. Meaning you should have breakpoints earlier in the fee structure? What would that – how would you know if your breakpoints are set too high?

A. I don't think we would know.

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EXHIBIT B-3

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF THOMAS H. HAYDEN

September 12, 2005

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[151]

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BY MR. BRICKMAN:

Q. Could you tell me, sir, how this proposal was supposed to have impacted Harris' profit (discretionary income)?

[152]

A. I'm not sure. I don't think that I was thinking about that.

I think I was thinking about what the appropriate break points would be in the fees, and, I think,

given this e-mail, it was John who was thinking more about the profitability and the bottom line.

Q. Okay. Apparently, John – is that John Raitt you were referring to?

A. I would expect it is.

Q. Because it says up at the top "meeting with John Raitt"?

A. Well, then, obviously, it was.

Q. Okay.

He is concerned about how a reduction in fees – is that what you put in your memo? That's what his concern was? There would be a reduction in fees?

MS. FELICELLO: Objection, calls for speculation.

BY THE WITNESS:

A. Well, what I stated was I don't think John was thinking about anything other than how [153] the reduction in fees would affect his bottom line or his profit, but that's his issue.

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EXHIBIT B-4

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF CLYDE S. McGREGOR

August 31, 2005

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[36]

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Q. So in general terms, then, as I gather from your year and a half at this fund on the [37] domestic side, if they have the cash and there is not some technical reason like there was for U.S. Stationers, when you buy a stock, you buy it for all of the global funds, and you do some allocation of those shares for all those funds at the same time; correct?

MS. FELICELLO: Objection, asked and answered.

THE WITNESS: In general that has been the case.

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EXHIBIT B-7

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF WILLIAM C. NYGREN

November 17, 2005

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[43]

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Q All right. Let me break that down, if we could. Win Murray is a research analyst at Harris?

A That is correct.

Q And is he one of your younger analysts?

A Yes, he is.

Q How long ballpark has he been with the company?

A Two or three years.

Q And does he do research for both the mutual funds and the separate accounts that you have at Harris Associates?

A Yes, all of our analysts do research for all of our clients.

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EXHIBIT B-8

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF JOHN R. RAITT

September 22, 2005

* * * * *

[236]

BY MR. BRICKMAN:

Q. Let me show you another document that we will mark as Exhibit 7.

MR SKINNER: 7 has got HA 1879 through 1887.

BY MR. BRICKMAN:

Q. Is that from your files, sir?

A. Yes.

Q. And on Page 1879, is that your calculation some way, I guess, of how much money has gone into the discretionary compensation pool from, I guess, the Oakmark fund?

A. These are some notes that I took in preparing for one of the trustee contract meetings sort of to remind myself of some numbers.

I believe what these were was taking a look at the – not the net contribution to the partner pool, but rather the – essentially, if you would, the net revenues that accrued to the firm after revenue sharing, marketing expenses, and the payments that are made to CDC but before any other expenses of the firm related to administering, servicing, managing the accounts.

Q. On the right do you see the number 75, then to the right of it 41.8?

[237]

A. Yes.

Q. What do those numbers reflect?

A. I'm not sure that I know with any accuracy what I was trying to come up with here.

Q. Let's go to Page 1884.

Do you see the middle of the page where it says "Advisor"?

A. Yes.

Q. And right underneath it you have the word "Profit maximization," dash, dash "LT"?

A. Correct.

Q. What does the LT stand for?

A. Long-term.

Q. Long-term. And you have underneath it, I guess, what would be done for profit maximization.

Is that what you meant by the items right underneath "Profit Maximization"?

A. I'm not quite sure what the first two statements are.

Q. Just read them into the record then.

A. It says, Close size, close to.

Q. And then what's the third one say?

A. And then "shift efforts to highest net [238] fee business."

Q. And what did you mean by that profit maximization by shifting efforts to highest net fee business?

MR SKINNER: Objection, misstates the document.

THE WITNESS: I believe what the discussion was is – this was in the context of what the appropriate fees would be for the funds and discussion of additional potential breakpoints.

As a part of the process, one of the things that we have looked at and discussed with the trustees over the years are the fee levels and the profitability of the Oakmark funds and the fee levels and the profitability of accounts with similar strategies, but different – different types of offerings, like institutional pension accounts or subadvised mutual fund accounts.

I think what the context was here is that, you know, it was in the context of with – when we think about the appropriate rates – the fee levels and the appropriate breakpoints and fair breakpoints for the fund – for the funds, it should be done with – the decision should be made [239] by the trustees and the advisor with reference to other accounts and the profitability on other accounts.

And I think what I was talking about is longer term here; that subject to our fiduciary duty as advisor to the funds, that if we were receiving fees that

were less on business that – for the Oakmark funds that was less attractive, then the – on a net profitability basis, if you would, after taking into account all the – all the expenses to manage each of the – each of those types of business, if we were receiving less money, net profitability for the Oakmark funds, that it was appropriate for us to think about over the long-term, you know, shifting, without probably growing those other businesses more than we might grow the Oakmark funds.

Q. And that's what you meant by "shift efforts to the highest net fee" – is that business that stands for?

A. I believe so, yes.

Q. Okay. And what you were telling them is that if they didn't pay you sufficient fees, you'd go start spending more of your time and effort on [240] those entities that paid the highest net fee, correct?

MR. SKINNER: Objection. Misstates the testimony.

THE WITNESS: We have – what I – what I was telling them was that subject to our fiduciary obligations to do the best that we can for every one of our clients, that over the long-term if we were to – if we were to choose – have the choice between growing a mutual fund account over – as opposed to an – taking on an institutional account, that we would – might tend to gravitate towards a higher fee business. However, at no time have I ever threatened to take away resources from the – you know, from the Oakmark funds if we weren't making enough money. We've still got a fiduciary obligation to do the best that we can for our shareholders.

BY MR. BRICKMAN:

Q. What were you going to shift then?

A. We would – we would shift – shift our growth.

Q. Your what?

A. Our growth.

[241]

Q. What do you mean your growth?

A. We would be – we would be likely to pursue growth in other businesses and possibly add additional resources to other businesses at the expense of the funds. Not at the expense of the funds, but in lieu of the funds.

In particular, one – one case here is we have several – several strategies that are very limited in capacity. Take, for instance, our concentrated business. In our concentrated business, we have closed down – closed down that business to new accounts. And if we were to reopen that business, we might reopen it to the highest fee accounts first. And once we got – we closed the – we closed the strategy to protect performance to shareholders, we felt that the business had grown to the point where size might be starting to have an impact on our ability to perform for the shareholders, at such point in time if we decided that that wasn't the case, then we might open – we would probably reopen in our most attractive businesses first on a net profitability basis.

Q. When you say profit maximization, you [242] were referring to the advisor's profit maximization, weren't you, on Page 1884?

A. Yes, sir, I believe so.

Q. And, in fact, when you say you didn't threaten the board, didn't you tell the board that if you and

Harris Associates didn't get the fee – fees that you wanted, that you would either close the fund or shift your efforts to other business that was more profitable?

MR. SKINNER: Objection, misstates the testimony.

THE WITNESS: I don't believe I ever – I don't recall ever making that statement.

BY MR. BRICKMAN:

Q. Look at Page 1885. Do you see the very bottom of the page? "Advisor is Profit Maximizer."

Do you see that, sir?

A. Uh-huh.

Q. And the next thing under that – you apparently have three items under that. One is will close; two is will close to high cost NTF; and the third one is will shift institutional.

Were those the three alternatives you [243] gave the board, sir, if you didn't – if Harris Associates didn't like the fee deal that was struck?

MR. SKINNER: Objection, misstates testimony.

THE WITNESS: As I said earlier, these were notes that – or thoughts that I had before going in to meet with the trustees, with the contracts committee.

* * * * *

EXHIBIT B-14

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

DEPOSITION OF GARY N. WILNER

September 13, 2005

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* * * * *

[167]

* * * * *

BY MR BRICKMAN:

Q. . . . And those reductions that you put into play would only be captured by the shareholders to their benefit in the future, if the assets under management grew even larger than they were when you put those breakpoints in; [168] correct?

A. That's correct.

* * * * *

EXHIBIT C-2

Harris Associates L.P.
Advisers' Profitability Analysis for years ended
December 31, 2000, 2001, 2002, 2003
(HA0010619, HA0005070, HA0001835,
HA0000458, HA0000459)

HARRIS ASSOCIATES, L.P.
SCHEDULE OF REVENUES AND EXPENSES OF HARRIS ASSOCIATES, L.P.
RELATED TO HARRIS ASSOCIATES INVESTMENT TRUST

Year Ended December 31, 2000

	$000s	%
REVENUES		
Investment Advisory Fees	$50,944	94%
Net Brokerage Commissions and Other Income	3,157	6%
Total Revenues	54,101	100%
EXPENSES		
Subsidiary Level		
Compensation (Note 2)	9,049	17%
Discretionary Compensation (Note 2)	13,333	25%
Occupancy (Note 3)	910	2%
Marketing Expenses (Note 4)	4,381	8%
Operating Expenses (Note 5)	2,392	4%
Subtotal - Expenses at Subsidiary Level	30,065	56%
Excess of Revenues over Expenses - Subsidiary Level	$24,036	44%
Parent Level		
Amortization of Intangible (Note 6)	7,362	14%
Interest Expense (Note 7)	5,983	11%
Subtotal	$13,346	25%
EXCESS OF REVENUE OVER EXPENSES	$10,690	20%

BEST AVAILABLE COPY

Harris Associates, L.P.
Schedule of Revenues and Expenses of Harris Associates, L.P.
Related to Harris Associates Investment Trust
Year Ended December 31, 2001
(In Thousands)

	2001		2000		1999	
	Amount	Percent	Amount	Percent	Amount	Percent
Revenues						
Investment Advisory Fees	$76,799	94%	$50,944	94%	$66,003	97%
Net Brokerage Commissions and Other Income	4,587	6%	3,157	6%	2,734	3%
Total Revenues	81,386	100%	54,101	100%	68,737	100%
Expenses						
Subsidiary Level						
Compensation (Note 2)	9,752	11%	9,049	17%	8,154	9%
Discretionary Compensation (Note 2)	27,037	33%	13,533	25%	33,968	38%
Occupancy (Note 3)	993	1%	910	2%	789	1%
Other Indirect Expenses (Note 4)	1,583	2%	2,192	4%	2,615	3%
Subtotal	38,365	47%	25,684	47%	45,522	51%
Subsidiary Level Marketing (Note 5)						
Fees Paid to Intermediaries	9,145	11%	3,581	7%	5,652	7%
General Marketing	2,025	2%	800	1%		0%
Subtotal - Marketing	11,170	14%	4,381	8%	5,652	7%
Subtotal - Expenses at Subsidiary Level	49,535	61%	30,065	56%	51,374	58%
Excess of Revenue over Expenses - Subsidiary Level	31,851	39%	24,036	44%	37,363	42%
Expenses at Parent Level:						
Amortization of Intangible Assets (Note 5)	7,566	10%	7,362	14%	8,787	10%
Interest Expense (Note 7)	8,226	10%	5,983	11%	7,089	8%
Subtotal	16,092	20%	13,345	25%	15,876	18%
Excess of Revenue over Expenses	$15,759	19%	$10,691	20%	$21,487	24%

Harris Associates Investment Trust
Breakdown of Revenues by Fund
Year Ended December 31, 2001
(in Thousands)

	Oakmark	Select	Small Cap	Equity and Income	Global	International	International Small Cap	Total
Revenues (Note 6)								
Advisory Fees	$ 28,241	$ 32,774	$ 2,559	$ 2,945	$ 457	$ 6,398	$ 1,388	$ 76,790
Net Commissions and Other Income	2,279	1,331	163	788	66	17	3	4,567
Total Revenues	30,520	34,105	2,702	3,733	523	6,412	1,391	81,356
Expenses (Note 6)								
Subsidiary Level								
Compensation	2,419	2,700	214	295	94	2,603	430	8,752
Discretionary Compensation	11,342	12,674	1,004	1,387	121	437	72	27,037
Occupancy	320	356	28	39	9	205	34	993
Other Indirect Expenses	587	654	52	72	10	178	29	1,583
Subtotal	14,668	16,387	1,298	1,794	234	3,423	565	38,365
Subsidiary Level Marketing								
Fees Paid to Intermediaries	2,660	4,554	245	697	36	822	131	9,145
General Marketing	778	868	69	95	13	175	29	2,025
Subsidiary Marketing	3,438	5,422	314	792	49	997	160	11,170
Subtotal - Expenses at Subsidiary Level	18,101	21,809	1,612	2,586	283	4,419	725	49,535
Excess Revenues over Expenses - Subsidiary Level	12,419	12,296	1,090	1,147	240	3,993	666	31,851
Parent Level - Direct Expenses								
Amortization of Intangible	2,650	3,294	261	351	51	815	134	7,956
Interest Expense	3,085	3,447	273	377	53	850	141	8,226
Subtotal - Direct Expenses to Parent	6,035	6,743	534	728	104	1,663	275	16,182
Excess of Revenue over Expenses	$ 6,384	$ 5,553	$ 556	$ 409	$ 136	$ 2,330	$ 391	$ 15,759
Profit Margin	20.92%	16.28%	20.57%	10.96%	26.00%	27.70%	28.10%	19.36%

CONFIDENTIAL

Harris Associates, L.P.
Adviser's Profitability Analysis
Related to Harris Associates Investment Trust
Year Ended December 31, 2002
(In Thousands)

	2003		2001		2000		1999	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Revenues								
Investment Advisory Fees	$ 115,918	97%	$ 79,799	94%	$ 53,844	94%	$ 86,003	97%
Net Brokerage Commissions and Other Income	3,782	3%	4,587	6%	3,157	6%	2,734	3%
Total Revenues	119,700	100%	81,386	100%	56,101	100%	88,737	100%
Expenses								
Subadvisory								
Compensation (Note 2)	10,383	9%	8,753	11%	9,049	17%	9,154	9%
Discretionary Compensation (Note 3) c & D	44,295	37%	27,037	33%	13,333	26%	30,968	36%
Occupancy (Note 3)	803	1%	953	1%	910	2%	785	1%
Other Indirect Expenses (Note 4)	1,878	2%	1,583	2%	2,392	4%	3,616	3%
Subtotal	57,358	49%	38,365	47%	25,684	47%	45,522	51%
Profit Margin before Marketing and Parent Level Exp	61,844	52%	43,021	53%	28,417	53%	43,215	49%
Distribution and Marketing (Note 5)								
Fees Paid to Intermediaries	17,548	15%	9,149	11%	3,561	7%	5,852	7%
General Marketing	2,114	2%	2,025	2%	820	1%	-	0%
Subtotal - Marketing	19,662	16%	11,173	14%	4,381	8%	5,852	7%
Subtotal - Expenses at Subsidiary Level	77,018	65%	49,535	61%	30,065	56%	51,374	58%
Excess of Revenue over Expenses - Subsidiary Level	42,682	35%	31,851	39%	24,036	44%	37,363	42%
Expenses (Income) at Parent Level:								
Transfer Agent Net (Assets) Loss	(399)	0%	282	0%	1,500	3%	9,767	10%
Amortization of Intangible Assets (Note 6)	7,283	7%	7,656	10%	7,562	14%	7,039	8%
Interest Expense (Note 7)	8,568	8%	8,226	10%	5,953	11%	15,078	16%
Subtotal	14,452	13%	16,264	20%	14,845	27%	$ 31,487	34%
Excess of Revenue over Expenses	$ 27,732	23%	$ 15,587	19%	$ 9,191	17%	$ 15,876	18%

Harris A[illegible] Sales, L.P.
Adviser's Profitability Analysis
Related to Harris Associates Investment Trust
Year Ended December 31, 2003
(In Thousands)

	2003		2002		2001	
	Amount	Percent	Amount	Percent	Amount	Percent
Revenues						
Investment Advisory Fees	$ 144,884	99%	$ 115,918	97%	$ 76,798	94%
Net Brokerage Commissions and Other Income	1,781	1%	3,282	3%	4,567	6%
Total Revenues	146,663	100%	119,200	100%	81,365	100%
Expenses						
Subsidiary Level						
Compensation (Note 2)	10,709	7%	10,383	9%	8,752	11%
Discretionary Compensation (Note 3)	54,270	37%	44,263	37%	27,057	33%
Occupancy (Note 3)	868	1%	953	1%	923	1%
Other Indirect Expenses (Note 4)	2,036	1%	1,878	2%	1,563	2%
Subtotal	67,534	46%	57,536	48%	38,355	47%
Profit Margin before Marketing and Parent Level	79,727	54%	61,664	52%	43,021	53%
Subsidiary Level Marketing (Note 5)						
Fees Paid to Intermediaries	23,027	16%	17,340	15%	9,145	11%
General Marketing	1,069	1%	2,114	2%	2,025	3%
Subtotal - Marketing	24,096	17%	19,452	16%	11,170	14%
Subtotal - Expenses at Subsidiary Level	92,304	63%	77,018	65%	49,525	61%
Excess of Revenue over Expenses - Subsidiary	53,681	37%	42,184	35%	31,841	39%
Expenses (Income) at Parent Level						
Transfer Agent Net (Income) Loss	(441)	0%	(799)	2%	202	0%
Amortization of Intangible Assets (Note 6)	8,319	6%	7,683	7%	7,668	10%
Interest Expense (Note 7)	-	0%	8,468	8%	8,236	10%
Subtotal	7,874	5%	14,452	12%	16,764	20%
Excess of Revenue over Expenses	$ 45,858	31%	$ 27,732	23%	$ 15,837	19%

Harris Associa. ..vestment Trust
Adviser's Profitability Analysis
Year Ended December 31, 2003
(in Thousands)

	Oakmark	Select	Small Cap	Equity and Income	Global	International	International Small Cap	Total
Revenues (Note E)								
Advisory Fees	$ 39,913	$ 41,444	$ 3,493	$ 27,617	$ 4,709	$ 22,559	$ 5,117	$ 144,884
Net Commissions and Other Income	545	471	86	536	98	36	8	1,781
Total Revenues	40,458	41,915	3,578	28,153	4,807	22,594	5,125	146,665
Each Fund's Percentage of Total Revenues	27.6%	28.6%	2.4%	19.2%	3.3%	15.4%	3.5%	100.0%
Expenses (Note B)								
Subsidiary Level								
Compensation	2,724	2,632	241	1,696	385	2,132	504	10,708
Discretionary Compensation	14,902	15,438	1,317	10,310	1,760	8,522	1,930	54,273
Occupancy	228	238	20	159	30	157	34	866
Other Indirect Expenses	556	577	49	387	72	371	84	2,095
Subtotal	18,410	19,074	1,627	12,811	2,281	11,181	2,553	67,936
Profit Margin before Marketing and Parent Level Exp	22,048	22,841	1,949	15,341	2,526	11,452	2,572	78,737
Expressed as a percentage	54.5%	54.5%	54.5%	54.5%	52.5%	50.6%	50.2%	53.7%
Subsidiary Level Marketing								
Fees Paid to Intermediaries	5,265	6,781	322	6,673	651	3,269	638	23,697
General Marketing	320	331	29	223	31	111	29	1,069
Subtotal Marketing	5,585	7,113	351	6,896	682	3,380	667	24,766
Subtotal Expenses at Subsidiary Level	23,995	26,187	1,978	19,708	3,163	14,562	3,114	92,704
Excess Revenues over Expenses - Subsidiary Level	16,461	15,728	1,598	8,448	1,644	8,032	2,012	53,961
Expressed as a percentage	40.7%	37.5%	44.7%	30.0%	34.2%	35.7%	39.2%	36.8%
Parent Level - Direct Revenues and Expenses								
Transfer Agency (Revenues)	(2,363)	(1,318)	(325)	(1,043)	(232)	(811)	(152)	(6,244)
Transfer Agency Expenses	2,193	1,225	302	970	216	754	141	5,800
Amortization of Intangible	2,291	2,376	203	1,596	272	1,283	291	8,315
Subtotal - Direct Expenses to Parent	2,127	2,283	179	1,523	256	1,226	280	7,874
Excess of Revenue over Expenses	$ 14,334	$ 13,445	$ 1,419	$ 6,924	$ 1,388	$ 6,806	$ 1,732	$ 46,088
Profit Margin	35.43%	32.08%	39.67%	24.59%	28.88%	30.25%	33.79%	31.42%

EXHIBIT C-18

INVESTMENT ADVISORY AGREEMENT FOR THE OAKMARK FUND

October 30, 2000

HARRIS ASSOCIATES INVESTMENT TRUST, a Massachusetts business trust registered under the Investment Company Act of 1940 (the "1940 Act") as an open-end diversified management investment company (the "Trust"), and HARRIS ASSOCIATES L.P., a Delaware limited partnership registered under the Investment Advisers Act of 1940 as an investment adviser (the "Adviser"), agree as follows:

1. Appointment of Adviser. The Trust appoints the Adviser to act as manager and investment adviser to The Oakmark Fund (the "Fund"), a series of the Trust, for the period and on the terms herein set forth. The Adviser accepts such appointment and agrees to render the services herein set forth, for the compensation herein provided.

2. Services of Adviser.

(a) The Adviser shall manage the investment and reinvestment of the assets of the Fund, subject to the supervision of the board of trustees of the Trust, for the period and on the terms set forth in this agreement. The Adviser shall give due consideration to the investment policies and restrictions and the other statements concerning the Fund in the Trust's Agreement and Declaration of Trust, bylaws and registration statements under the 1940 Act and the Securities Act of 1933 (the "1933 Act"), and to the provisions of the Internal Revenue Code applicable to the Trust

as a regulated investment company. The Adviser shall be deemed for all purposes to be an independent contractor and not an agent of the Trust or the Fund, and unless otherwise expressly provided or authorized, shall have no authority to act or represent the Trust or the Fund in any way.

(b) The Adviser shall place all orders for the purchase and sale of portfolio securities for the account of the Fund with brokers or dealers selected by the Adviser, although the Fund will pay the actual brokerage commissions on portfolio transactions in accordance with Paragraph 4. In executing portfolio transactions and selecting brokers or dealers, the Adviser will use its best efforts to seek on behalf of the Fund the best overall terms available for any transaction. The Adviser shall consider all factors it deems relevant, including the breadth of the market in the security, the price of the security, the financial condition and execution capability of the broker or dealer, and the reasonableness of the commission, if any (for the specific transaction and on a continuing basis).

(c) To the extent contemplated by the Trust's registration statement under the 1933 Act, in evaluating the best overall terms available, and in selecting the broker or dealer to execute a particular transaction, the Adviser may also consider the brokerage and research services (as those terms are defined in Section 28(e) of the Securities Exchange Act of 1934) provided to the Fund and/or other accounts over which the Adviser or an affiliate of the Adviser exercises investment discretion. Consistent with the Rules of Fair Practice of the National Association of Securities Dealers, Inc. and subject to seeking the most favorable combination of net price and execution

available, the Adviser may consider sales of shares of the Fund as a factor in the selection of broker-dealers to execute portfolio transactions for the Fund. The Adviser is authorized to pay to a broker or dealer who provides such brokerage and research services a commission for executing a portfolio transaction for the Fund which is in excess of the amount of commission another broker or dealer would have charged for effecting that transaction if, but only if, the Adviser determines in good faith that such commission was reasonable in relation to the value of the brokerage and research services provided by such broker or dealer, viewed in terms of that particular transaction or in terms of all of the accounts over which investment discretion is so exercised.

3. **Services other than as Adviser.** The Adviser (or an affiliate of the Adviser) may act as broker for the Trust in connection with the purchase or sale of securities by or to the Trust if and to the extent permitted by procedures adopted from time to time by the board of trustees of the Trust. Such brokerage services are not within the scope of the duties of the Adviser under this agreement, and, within the limits permitted by law and the trustees, the Adviser (or an affiliate of the Adviser) may receive brokerage commissions, fees or other remuneration from the Trust for such services in addition to its fee for services as Adviser. Within the limits permitted by law, the Adviser may receive compensation from the Trust for other services performed by or for the Trust which are not within the scope of the duties of the Adviser under this agreement

4. **Expenses to be paid by Adviser.** The Adviser shall furnish to the Trust, at its own expense, such office space and all office facilities, equipment

and personnel necessary to render the services set forth in paragraph 2 above. The Adviser shall also assume and pay all expenses incurred by it related to the placement of securities orders, and all expenses of marketing shares of the Trust.

5. Expenses to be paid by the Trust. The Trust shall pay all expenses not expressly assumed by the Adviser, including but not limited to: all charges of depositories, custodians and other agencies for the safekeeping and servicing of its cash, securities and other property and of its transfer agents, fund accounting agents, registrars and its dividend disbursing and redemption agents, if any; all charges of legal counsel and of independent auditors; all compensation of trustees other than those affiliated with the Adviser and all expenses incurred in connection with their services to the Trust; all costs of borrowing money; all expenses of publication of notices and reports to its shareholders and to governmental bodies or regulatory agencies; all expenses of proxy solicitations of the Trust or its board of trustees with respect to the Fund; all expenses of shareholder meetings; all expenses of typesetting of the Fund's prospectus and of printing and mailing copies of the prospectus furnished to each then-existing shareholder or beneficial owner; all taxes and fees payable to federal, state or other governmental agencies, domestic or foreign; all stamp or other transfer taxes; all expenses of printing and mailing certificates for shares of the Trust; all expenses of bond and insurance coverage required by law or deemed advisable by the Trust's board of trustees; all expenses of maintaining the registration of shares of the Trust under the 1933 Act and of qualifying and maintaining qualification of shares of the Trust under the securities laws of such United

States jurisdictions as the Trust may from time to time reasonably designate and all expenses of maintaining the registration of the Trust under the 1940 Act; and all fees, dues and other expenses related to membership of the Trust in any trade association or other investment company organization. In addition to the payment of expenses, the Trust shall also pay all brokers' commissions and other charges relating to the purchase and sale of portfolio securities.

6. Compensation of Adviser. For the services to be rendered and the charges and expenses to be assumed and to be paid by the Adviser hereunder, the Trust shall pay out of Fund assets to the Adviser a monthly fee, based on the Fund's net assets as of the last day of the preceding month, at the annual rate of 1.00% on the first $2 billion of net assets, .90% on the next $1 billion of net assets, .80% on the next $2 billion of net assets and .75% on net assets in excess of $5 billion. The fee for a month shall be paid as soon as practicable after the last day of that month. The fee payable hereunder shall be reduced proportionately during any month in which this agreement is not in effect for the entire month.

7. Limitation of expenses of the Fund. The total expenses of the Fund, exclusive of taxes, interest and extraordinary litigation expenses, but including fees paid to the Adviser, shall not in any fiscal year of the Trust exceed the most restrictive limits prescribed by any state in which Fund shares are then being offered for sale, and the Adviser agrees to reimburse the Fund for any sums expended for such expenses in excess of that amount. Brokers' commissions and other charges relating to the purchase and sale of portfolio securities shall not be regarded as expenses.

8. Services of Adviser not exclusive. The services of the Adviser to the Trust hereunder are not exclusive, and the Adviser shall be free to render similar services to others so long as its services under this agreement are not impaired by such other activities.

9. Liability of Adviser. The Adviser shall not be liable to the Trust or its shareholders for any loss suffered by the Trust or its shareholders from or as a consequence of any act or omission of the Adviser, or of any of the partners, employees or agents of the Adviser, in connection with or pursuant to this agreement, except by reason of willful misfeasance, bad faith or gross negligence on the part of the Adviser in the performance of its duties or by reason of reckless disregard by the Adviser of its obligations and duties under this agreement.

10. Liability of Trust. The obligations of the Trust hereunder shall not be binding upon any of the trustees, shareholders, nominees, officers, agents or employees of the Trust, personally, but shall bind only the assets and property of the Trust as provided in the Agreement and Declaration of Trust of the Trust.

11. Use of Adviser's name. The Trust may use the name "Harris Associates Investment Trust," or any other name derived from the name "Harris Associates;" and the name "Oakmark" only for so long as this agreement or any extension, renewal or amendment hereof remains in effect, including any similar agreement with any organization which shall have succeeded to the business of the Adviser as investment adviser. At such time as this agreement or any extension, renewal or amendment hereof, or such other similar agreement shall no longer be in effect,

the Trust will (by amendment of its Agreement and Declaration of Trust, if necessary) cease to use any name derived from the name "Harris Associates," any name similar thereto or any other name indicating that it is advised by or otherwise connected with the Adviser, or with any organization which shall have succeeded to the Adviser's business as investment adviser, and shall cease to use the name "Oakmark" or any name derived from the name "Oakmark." The consent of the Adviser to the use of such names by the Trust shall not prevent the Adviser's permitting any other enterprise, including another investment company, to use such name or names.

12. Duration and renewal.

(a) Unless terminated as provided in section 13, this agreement shaft continue in effect until October 31, 2001, and thereafter from year to year only so long as such continuance is specifically approved at least annually (a) by a majority of those trustees who are not interested persons of the Trust or of the Adviser, voting in person at a meeting called for the purpose of voting on such approval, and (b) by either the board of trustees of the Trust or a vote of the holders of a majority of the outstanding shares of the Fund (which term as used throughout this agreement shall be construed in accordance with the definition of "vote of a majority of the outstanding voting securities of a company" in section 2(a)(42) of the 1940 Act).

(b) Any approval of this agreement by the holders of a majority of the outstanding shares of the Fund shall be effective to continue this agreement notwithstanding that it has not been approved by the vote of a majority of the outstanding shares of the Trust,

unless such approval shall be required by any other applicable law or otherwise.

13. Termination. This agreement may be terminated at any time, without payment of any penalty, by the board of trustees of the Trust, or by a vote of the holders of a majority of the outstanding shares of the Fund, upon 60 days' written notice to the Adviser. This agreement may be terminated by the Adviser at any time upon 60 days' written notice to the Trust. This agreement shall terminate automatically in the event of its assignment (as defined in section 2(a)(4) of the 1940 Act).

14. Amendment. This agreement may not be amended without the affirmative vote (a) of a majority of those trustees who are not "interested persons" (as defined in Section 2(a)(19) of the 1940 Act) of the Trust and (b) of the holders of a majority of the outstanding shares of the Fund.

Dated: October 30, 2000

HARRIS ASSOCIATES INVESTMENT TRUST

By: /s/ VICTOR A. MORGENSTERN

HARRIS ASSOCIATES L.P.

by Harris Associates, Inc.

its General Partner

By: /s/ ROBERT M. LEVY

* * * * *

EXHIBIT C-32

—Original Message—
From: Tom Hayden [mailto:thayden@greenhousecom.net]
Sent: Tuesday, September 28, 2004 8:30 PM
To: victor morgenstern
Subject: RE: Meeting with John Raitt

Hi Vic.

I don't think John was thinking about anything other than how our total proposal would impact Harris' profit (discretionary income). I believe he is concerned about how a reduction in fees and the elimination of soft dollars will reduce their "bottom line". The "offer" to absorb the total CCO cost was lost in the total impact of reduced fees and the elimination of soft dollars. John continues to express the need to get input from his partners. John has not said this, but I believe his partners have told him they will not accept any reduction of current fees (including the elimination of the current soft dollar schedule). He has told me "they" are willing to look at lower breakpoints going forward, but nothing that reduces fees as they now stand.

I think we should see what John comes back with, then let the committee evaluate what they propose. It's probably best that this email doesn't go anywhere beyond the committee. I'll forward it the rest of the committee.

Thanks.

Tom

EXHIBIT C-33

HARRIS ASSOCIATES INVESTMENT TRUST

Minutes of Meeting of Committee on Management Contracts of the Board of Trustees

September 11, 2002

A meeting of the committee on management contracts of the board of trustees of Harris Associates Investment Trust, a Massachusetts business trust (the "Trust"), was held at 10:30 a.m. on Wednesday, September 11, 2002, at the offices of the Trust, Suite 500, Two North LaSalle Street, Chicago, Illinois 60602, upon call of the chairman of the committee and pursuant to notice.

The following members of the committee, constituting a quorum, were present as follows:

Michael J. Friduss
Thomas H. Hayden
Victor A. Morgenstern
Marv R. Rotter

Also present were Robert M. Levy, Anita M. Nagler, John R. Raitt, Janet L. Reali, and Kristi L. Rowsell, officers of the Trust; and Cameron S. Avery and Mary T. Capasso of Bell, Boyd & Lloyd LLC, counsel to the Trust and the independent trustees. Messrs. Hayden, Morgenstern and Rotter participated in the meeting by conference telephone, by means of which all persons participating in the meeting could hear each other. Mr. Friduss, chairman of the committee,

was chairman and Ms. Reali was secretary of the meeting.

Mr. Friduss stated that the meeting was called to complete the committee's review of the Funds' advisory contracts and to consider whether any changes to the contracts should be recommended before the contracts were presented to the full board for renewal and approval in October. He noted that the committee had previously reviewed comparative data prepared by Lipper, Inc. and profitability analyses prepared by Harris Associates L.P. (the "Adviser"). He said that the consideration of breakpoints for the Equity and Income Fund was the only remaining issue to discuss.

Minutes. The minutes of the July 12, 2002 meeting of the committee were unanimously approved.

Review of Advisory Fee Breakpoints. Mr. Friduss stated that he had met earlier with Clyde McGregor regarding the possible addition of breakpoints to the current advisory fee structure for the Equity and Income Fund: Mr. Friduss reported that Mr. McGregor strongly opposed the addition of breakpoints for two reasons: (1) the Fund's current expense ratio was relatively low relative to its competitors and (2) the addition of breakpoints would decrease even further the Adviser's relatively low profitability in managing the Fund, particularly in light of existing arrangements with third-party administrators. Mr. Friduss stated that Mr. McGregor indicated that in lieu of implementing breakpoints and decreasing the Adviser's profitability, Mr. McGregor would rather close the Fund to new investors. Mr. Friduss stated that based on Mr. McGregor's sentiment, he favored recommending the renewal of the Equity and Income Fund's existing advisory con-

tract without the addition of breakpoints. The other committee members concurred with Mr. Friduss' conclusion.

Mr. Avery reviewed the significance of the Fund's expense ratio and the Adviser's profitability in the committee's consideration of the appropriateness of the Fund's advisory fee. He reminded the committee that the Adviser's profitability was a factor for consideration; however, profitability should be considered before the effect of any payments made by the Adviser to intermediaries for their distribution services.

After discussion, the committee unanimously agreed to recommend that the board approve the renewal of each of the existing advisory contracts for the Funds, with no changes.

Adjournment. There was no further business and the meeting was adjourned.

/s/ JANET L. REALI
Janet L. Reali
Secretary

Approved:

/s/ MICHAEL J. FRIDUSS
Michael J. Friduss
Chairman

EXHIBIT C-34

HALP Management Fee Justification
Global Fund and Equity & Income Fund
Break Points

- Fee and expense levels are close to average, but performance is top tier.
- HALP is investing in the business to support fund growth:
  - Trade Order Management System $500K/yr.
  - Disaster Recovery $200K/yr.
  - Analyst Hires – 2 Analysts } last 2 years $500K+
    2 Research Assistants
- Need to pay Partners well to compete for top tier talent (Hedge Funds)
- Margin Level at Equity & Income is already lowest by far. Break point makes it even less attractive for us. We will reserve our limited investment capacity for our higher fee business.
- Need to be competitive with pricing of alternative products at HALP.
- 1/3 of firm's clients are in all-cap Balanced Strategy. Full fee schedule for these accounts is superior to Equity & Income Fund.

* * * * *

EXHIBIT C-36

TRANSFER AGENCY AND SERVICE AGREEMENT
between
HARRIS ASSOCIATES INVESTMENT TRUST
and
NVEST SERVICES COMPANY, INC.

* * * * *

TRANSFER AGENCY AND SERVICE AGREEMENT

AGREEMENT made as of this 1st day of September, 1999, by and between HARRIS ASSOCIATES INVESTMENT TRUST, a Massachusetts business trust, having its principal office and place of business at Two North LaSalle Street Chicago, Illinois 60602 (the "Fund"), and NVEST SERVICES COMPANY, INC., a Massachusetts corporation having its principal office and place of business at 399 Boylston Street, Boston, Massachusetts 02116 (the "Transfer Agent").

WHEREAS, the Fund is authorized to issue shares in separate series, with each such series representing interests in a separate portfolio of securities and other assets;

WHEREAS, the Fund currently offers shares in seven series, such series being named in the attached Schedule A, which may be amended by the parties from time to time (each such series, together with all other series subsequently established by the Fund and made subject to this Agreement in accordance with Section 17 hereof, being herein referred to as a "Portfolio," and collectively as the "Portfolios");

WHEREAS, the Fund, on behalf of the Portfolios, desires to appoint the Transfer Agent as its transfer agent, dividend disbursing agent, and agent in connection with certain other activities, and the Transfer Agent desires to accept such appointment; and

WHEREAS, the Transfer Agent intends to engage Boston Financial Data Services, Inc. (the "Sub-Transfer Agent") to perform certain of the services to be provided by the Transfer Agent hereunder and enter into a Sub-Transfer Agency and Service Agreement with the Sub-Transfer Agent (the "Sub-TA Agreement") to that effect, and the Fund hereby acknowledges the Transfer Agent's intent to so engage the Sub-Transfer Agent.

NOW, THEREFORE, in consideration of the mutual covenants herein contained, the parties hereto agree as follows:

1. Appointment and Duties

1.1 *General.* Subject to the terms and conditions set forth in this Agreement, the Fund, on behalf of the Portfolios, hereby employs and appoints the Transfer Agent to act as, and the Transfer Agent agrees to act as, its transfer agent for the authorized and issued shares of beneficial interest of the Fund ("Shares"), dividend disbursing agent, and agent in connection with any accumulation, open-account, or similar plan provided to the shareholders of each of the respective Portfolios of the Fund ("Shareholders") and set out in the currently effective prospectus(es) and statement(s) of additional information of the Fund, including, without limitation, any periodic investment plan or periodic withdrawal program.

In accordance with procedures established from time to time by agreement between the Fund and the Transfer Agent, the Transfer Agent agrees that it will perform the various services set forth in Schedule B hereto. As the Fund and the Transfer Agent may, from time to time, mutually agree in writing, the Transfer Agent may at times perform only a portion of the services listed in Schedule B, and the Fund or its agent may perform such services.

1.2 *Retirement Accounts.* With respect to certain retirement plans or accounts (such as individual retirement accounts ("IRAs"), SIMPLE IRAs, SEP IRAs, Roth IRAs, Education IRAs, and 403(b) Plans (such accounts, "Retirement Accounts")), the Transfer Agent, at the request of the Fund, may provide or arrange for the provision of appropriate prototype plans as well as provide or arrange for the provision of various services to such plans and/or accounts, which services may include plan custodian services, account set-up, maintenance, and disbursements as well as such other services as the parties hereto shall mutually agree upon.

If at any time and for any reason the Transfer Agent, any of its agent or sub-contractors, or any of their affiliates chooses to resign as custodian of any or all Retirement Accounts, the Transfer Agent will give the Fund at least eighty-five (85) days' prior written notice and shall not be required to designate a successor custodian. If either party chooses to terminate this Agreement pursuant to Section 13 hereof, the Transfer Agent, any of its agents or sub-

contractors, or any of their affiliates may thereupon resign as custodian in respect to any or all of the Retirement Accounts upon eighty-five (85) days' prior written notice to the Fund. In either such event, the Fund will promptly distribute notice of the custodian's resignation to such persons and in such manner as are called for under the applicable provisions of the Retirement Account and in form and content satisfactory to and signed by the Transfer Agent. The Fund shall be responsible for obtaining a successor custodian for all Retirement Accounts.

1.3 *Review and Maintenance of Fund Prototype Retirement Plans or Account Materials.*

(a) If the Fund develops and makes available its own retirement plan prototypes or account materials (the "Fund Prototype(s)") for use in connection with a Retirement Account or Accounts, the Fund, subject to the terms set forth below, may appoint the Transfer Agent, one of its agent or sub-contractors, or an affiliate thereof as the custodian with respect to such Retirement Accounts.

(b) The Fund agrees that the Fund Prototypes will comply with applicable sections of the Internal Revenue Code of 1986, as amended (the "Code"), and regulations promulgated thereunder as in effect at the time. The Fund will be responsible for establishing, maintaining, and updating the Fund Prototypes in compliance with the Code and all other applicable federal or state law or regulations, when changes in the law require such updating.

(c) The Fund agrees that the Fund Prototypes are the responsibility of the Fund and further agrees that it will indemnify, defend, and hold harmless the Transfer Agent, its affiliates, successors, representatives, and assigns from and against any and all losses, damages, costs, charges, expenses, including reasonable fees for counsel, taxes, penalties, and liabilities (collectively, "Losses") arising out of or attributable to the use of a Fund Prototype by the Fund or the Transfer Agent, its agents, employees, representatives, or any other person acting on a Fund's behalf, except to the extent that such Losses arise out of or are attributable to the negligence, bad faith, or willful misconduct of the Transfer Agent (or its agents, affiliates, successors, or assigns), unless such negligence is a result of complying with a Fund Prototype. This indemnification obligation will survive termination of this Agreement.

(d) The Fund agrees that any modifications made by the Fund to a Fund Prototype without the Transfer Agent's written consent or the required written consent of any of the Transfer Agent's agents or sub-contractors or any of their affiliates shall not increase the liabilities or responsibilities of the Transfer Agent or that of such agent, sub-contractor, or affiliate as custodian or limit the Transfer Agent's ability or that of that of its agent or sub-contractor, or any of their affiliates to resign as custodian as provided hereunder. The Fund will furnish the Transfer Agent with a copy of each Fund Prototype. The Transfer Agent

shall not be required to review, comment, or advise on such Fund Prototypes.

1.4 *Blue Sky.* The Fund shall (a) identify to the Transfer Agent in writing those transactions and assets to be treated as exempt from blue sky reporting for each State and (b) verify the establishment of transactions for each State on the system prior to activation and thereafter monitor the daily activity for each State. The responsibility of the Transfer Agent for the Fund's blue sky State registration status is solely limited to the initial establishment of transactions subject to blue sky compliance by the Fund and providing a system that will enable the Fund to monitor the total number of Shares sold in each State.

2. Third Party Administrators for Defined Contribution Plans

2.1 The Fund may decide to make available to certain of its customers a qualified plan program (the "Program") pursuant to which such customers ("Employers") may adopt certain plans (each, a "Plan," and collectively, "Plans") for the benefit of Plan participants (the "Participants"), such Plans being qualified under Section 401(a) of the Code, and administered by third party administrators, which may be "administrators" as defined in the Employee Retirement Income Security Act of 1974, as amended ("TPA(s)").

2.2 In accordance with the procedures established in Schedule 2.2 hereto entitled "Third Party Administrator Procedures," as may be amended by the Transfer Agent and the Fund from time

to time ("Schedule 2.2"), the Transfer Agent shall:

(a) treat Shareholder accounts established by the Plans in the name of the Plan Trustees, the Plans, or TPAs, as the case may be, as omnibus accounts;

(b) maintain omnibus accounts on its records in the name of the TPA or its designee as the Trustee for the benefit of the Plan; and

(c) perform all services under Section 1 as transfer agent of the Funds and not as a record-keeper for the Plans.

2.3 Transactions identified under Section 2 of this Agreement shall be deemed exception services ("Exception Services") when such transactions:

(a) require the Transfer Agent or its sub-agent to use methods and procedures other than those usually employed by the Transfer Agent or its sub-agent to perform services described under Section 1 of this Agreement;

(b) involve the provision of information to the Transfer Agent or its sub-agent after the commencement of the nightly processing cycle of the transfer agency data processing system then in use by the Transfer Agent or its sub-agent (the "System"); or

(c) require more manual intervention by the Transfer Agent or its sub-agent, either in the entry of data or in the modification or amendment of reports generated by the System than is usually required by non-retirement plan and pre-nightly transactions.

3. Fees and Expenses

3.1 *Fee Schedule.* For the performance by the Transfer Agent pursuant to this Agreement, the Fund agrees to pay the Transfer Agent fees as set forth in the attached fee schedule ("Schedule 3.1"). Such fees and out-of-pocket expenses and advances identified under Section 3.2 below may be changed from time to time subject to mutual written agreement between the Fund and the Transfer Agent.

3.2 *Out-of-Pocket Expenses.* In addition to the fees paid under Section 3.1 above, the Fund agrees to reimburse the Transfer Agent for the Transfer Agent's reasonable out-of-pocket expenses, including, but not limited to, confirmation production, postage, investor statements, telephone, telecommunication and line charges, microfilm, microfiche, checks, forms (including year end forms), wire fees, mailing/receiving and tabulating proxies, records storage, costs associated with certain specialty products, systems, or services, as applicable (such as "Investor," "Voice," "Fan," and "Vision"), or advances incurred by the Transfer Agent for the items set out in Schedule 3.1 attached hereto. In addition, any other expenses reasonably incurred by the Transfer Agent at the request or with the consent of the Fund will be reimbursed by the Fund.

3.3 *Postage.* Postage for mailing of dividends, proxies, Fund reports, and other mailings to all shareholder accounts shall be advanced to the Transfer Agent by the Fund at least seven

(7) days prior to the mailing date of such materials.

3.4 *Invoices.* The Fund agrees to pay all fees and reimbursable expenses within thirty (30) days following the receipt of the respective billing notice, except for any fees or expenses that are subject to good faith dispute. In the event of such a dispute, the Fund may withhold only that portion of the fee or expense subject to the good faith dispute. The Fund shall notify the Transfer Agent in writing within twenty-one (21) calendar days following the receipt of each billing notice if the Fund is disputing any amounts in good faith. If the Fund does not provide such notice of dispute within the required time, the billing notice will be deemed accepted by the Fund.

* * * * *

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed in their names and on their behalf by and through their duly authorized officers, as of the day and year first above written.

HARRIS ASSOCIATES INVESTMENT TRUST

BY: /s/ [Illegible]

(Hereunto Duly Authorized)

NVEST SERVICES COMPANY, INC.

BY: /s/ CHRISTOPHER L. WILSON

Christopher L. Wilson

* * * * *

SCHEDULE B

SERVICES TO BE PROVIDED BY THE TRANSFER AGENT

Perform the customary services of a transfer agent, dividend disbursing agent, and, as relevant, agent in connection with accumulation, open-account or similar plan (including any periodic investment plan or periodic withdrawal program), including, but not limited to, the following:

1. maintain all Shareholder accounts;
2. process transactions, including, but not limited to, new account set up, transfer of Share ownership, exchange of Shares, telephone transactions, and literature requests;
3. prepare Shareholder meeting lists;
4. mail Shareholder proxies, Shareholder reports, and prospectuses to current Shareholders;
5. receive and tabulate Shareholder proxies;
6. withhold taxes on U.S. resident and non-resident alien accounts;
7. prepare and file U.S. Treasury Department Forms 1099 and other appropriate forms required with respect to dividends and distributions by federal authorities for all Shareholders;
8. prepare and mail confirmation forms and statements of account to Shareholders for all purchases and redemptions of Shares and other confirmable transactions in Shareholder accounts;

9. prepare and mail activity statements for Shareholders;

10. provide Shareholder account information through various means, including, but not limited to, telephone calls, correspondence, and research;

11. receive for acceptance orders for the purchase of Shares and promptly deliver payment and appropriate documentation thereof to the custodian of the Fund authorized pursuant to the Fund's Declaration of Trust (the "Custodian");

12. pursuant to purchase orders, issue the appropriate number of Shares and hold such Shares in the appropriate Shareholder account;

13. receive for acceptance redemption requests and redemption directions either in correspondence; via telephone, facsimile, transmission, or through NSCC or any other method deemed appropriate by the Fund and deliver the appropriate documentation thereof to the Custodian;

14. at the appropriate time as and when it receives monies paid to it by the Custodian with respect to any redemption, pay over or cause to be paid over in the appropriate manner such monies as instructed by the redeeming Shareholders;

15. with respect to the transactions in Items 11, 12, 13, and 14 above, the Transfer Agent shall execute transactions directly with broker-dealers authorized by the Fund;

16. effect transfers of Shares by the registered owners thereof upon receipt of appropriate instructions;

17. prepare and transmit payments for dividends and distributions declared by the Fund on behalf of the applicable Portfolio;

18. maintain such bank accounts (which accounts may be in the name of the Transfer Agent or a subagent thereof) as the Transfer Agent shall deem necessary to the performance of its duties hereunder, including, but not limited to, the processing of Share purchases and redemptions and the payment of Portfolio dividends; any income or expense associated with any such account shall accrue to or be borne by the Transfer Agent;

19. if applicable, issue replacement certificates for those certificates alleged to have been lost, stolen, or destroyed upon receipt by the Transfer Agent of indemnification satisfactory to the Transfer Agent and protecting the Transfer Agent and the Fund; the Transfer Agent, at its option, may issue replacement certificates in place of mutilated stock certificates upon presentation thereof and without such indemnity;

20. report abandoned property to the various states as authorized by the Fund according to policies and principles agreed upon by the Fund and the Transfer Agent;

21. maintain records of account for and advise the Fund and its Shareholders as to the foregoing;

22. record the issuance of Shares of the Fund and maintain a record of the total number of Shares of the Fund that are authorized, based upon data provided to it by the Fund, and issued and outstanding; the Transfer Agent shall also provide the Fund on a regular basis with the total number of Shares that are authorized and issued and outstanding and shall have no obligation, when recording the issuance of Shares, to monitor the issuance of such Shares or to take cognizance of any laws relating to the issue or sale of such Shares, which functions shall be the sole responsibility of the Fund;

23. maintain a daily record and produce a daily report for the Fund of all transactions, receipts, and disbursements of money and securities to and from Shareholders and deliver a copy of such report for the Fund for each business day to the Fund no later than 10:00 AM Eastern Time, or such earlier time as the Fund may reasonably require, on the next business day;

24. register and maintain accounts through Networking and accept and effectuate the purchase, redemption, transfer and exchange of Shares in such accounts through Fund/SERV (Networking and Fund/SERV being programs operated by NSCC on behalf of NSCC's participants, including the Fund), in accordance with instructions transmitted to and received by the Transfer Agent by transmission from NSCC on behalf of broker-dealers and banks that have been established or in accordance with the instructions of authorized persons as

hereinafter defined on the dealer file maintained by the Transfer Agent; issue instructions to the Fund's banks for the settlement of transactions between the Fund and NSCC (acting on behalf of its broker-dealer and bank participants); provide account and transaction information from the affected Fund's records on the System in accordance with NSCC's Networking and Fund/SERV rules for those broker-dealers; and maintain Shareholder accounts on the System through Networking; and

25. provide a system that will enable the Fund to monitor the total number of Shares of each Portfolio sold in each state (Blue Sky reporting).

HARRIS ASSOCIATES INVESTMENT TRUST

BY: /s/ [Illegible]

(Hereunto Duly Authorized)

NVEST SERVICES COMPANY, INC.

BY: /s/ CHRISTOPHER L. WILSON

EXHIBIT C-37

CUSTODIAN AGREEMENT

AGREEMENT made as of this 1st day of April, 2002, between HARRIS ASSOCIATES INVESTMENT TRUST, a business trust organized under the laws of the Commonwealth of Massachusetts (the "Fund"), and INVESTORS BANK & TRUST COMPANY, a Massachusetts trust company (the "Bank").

The Fund, an open-end management investment company on behalf of the portfolios/series listed on Appendix A hereto (as such Appendix A may be amended from time to time) (each a "Portfolio" and collectively, the "Portfolios"), desires to place and maintain all of its portfolio securities and cash in the custody of the Bank. The Bank has at least the minimum qualifications required by Section 17(f)(1) of the Investment Company Act of 1940 (the "1940 Act") to act as custodian of the portfolio securities and cash of the Fund, and has indicated its willingness to so act, subject to the terms and conditions of this Agreement.

NOW, THEREFORE, in consideration of the premises and of the mutual agreements contained herein, the parties hereto agree as follows:

1. Bank Appointed Custodian. The Fund hereby appoints the Bank as custodian of its Portfolio Securities (as defined below) and cash delivered to the Bank as hereinafter described and the Bank hereby accepts appointment as such custodian and agrees to act as such upon the terms and conditions hereinafter set forth. For the services rendered pursuant to this Agreement the Fund agrees to pay to the Bank

fees as may be agreed to from time to time in writing between the parties.

* * * * *

HARRIS ASSOCIATES INVESTMENT TRUST

BY: /s/ KRISTI L. ROWSELL

Name: Kristi L. Rowsell
Title: Treasurer

INVESTORS BANK & TRUST COMPANY

BY: /s/ MICHAEL F. ROGERS

Name: Michael F. Rogers
Title: President

EXHIBIT C-38

ADMINISTRATION AGREEMENT

AGREEMENT made as of April 1, 2002 by and between HARRIS ASSOCIATES INVESTMENT TRUST, a business trust organized under the laws of the Commonwealth of Massachusetts (the "Fund"), and INVESTORS BANK & TRUST COMPANY, a Massachusetts trust company (the "Bank").

WHEREAS, the Fund, a registered investment company under the Investment Company Act of 1940, as amended (the "1940 Act"), consisting of the separate portfolios listed on Appendix A hereto; and

WHEREAS, the Fund desires to retain the Bank to render certain administrative services to the Fund and the Bank is willing to render such services.

NOW, THEREFORE, in consideration of the mutual covenants herein set forth, it is agreed between the parties hereto as follows:

1. Appointment. The Fund hereby appoints the Bank to act as Administrator of the Fund on the terms set forth in this Agreement. The Bank accepts such appointment and agrees to render the services herein set forth for fees that may be agreed to from time to time in writing between the parties.

* * * * *

3. Duties of Administrator. Subject to the supervision and direction of the Board of Trustees of the Fund, the Bank, as Administrator, will assist in conducting various aspects of the Fund's administrative operations and undertakes to perform the services described in Appendix B hereto. The Bank may, from time to time, perform additional duties and

functions which shall be set forth in an amendment to such Appendix B executed by both parties.

In performing all services under this Agreement, the Bank shall act in conformity with the Fund's Declaration and By-Laws and the 1940 Act, as the same may be amended from time to time, and the investment objectives, investment policies and other practices and policies set forth in the Fund's Registration Statement, as the same may be amended from time to time. Notwithstanding any item discussed herein, the Bank has no discretion over the Fund's assets or choice of investments and cannot be held liable for any problem relating to such investments.

* * * * *

5. Fees and Expenses.

(a) For the services rendered by the Bank hereunder, the Fund will pay to the Bank such fees at such rate as shall be agreed upon in writing by the parties from time to time. The Fund will also pay or reimburse the Bank from time to time for any transfer taxes payable upon any transfers made hereunder, and for all necessary proper disbursements, expenses and charges reasonably made or reasonably incurred by the Bank in the performance of this Agreement (including any duties listed on any Schedule hereto, if any) including any indemnities for any loss, liabilities or expense to the Bank as provided herein. The Bank will also be entitled to reimbursement by the Fund for all reasonable expenses incurred in conjunction with termination of this Agreement and any conversion or transfer work done in connection therewith unless the Fund terminates this Agreement pursuant to Sections 7(c) or 7(d).

(b) Fees and expenses will be calculated monthly. Fees and expenses owed to the Bank for any month may be charged against any cash balance held by the Fund beginning on the first (1st) business day after the end of such month based on information then available. Fees charged to an account may result in an overdraft that will be subject to normal interest charges. The Fund will have thirty (30) days after the receipt of an invoice to dispute any charge that appears on such invoice. After such thirty (30) day period, the invoice will be deemed to be complete and accurate and may no longer be disputed.

(c) The Bank shall not be required to pay any expenses incurred by the Fund.

(d) In the case of the following transactions, not in the ordinary course of business, namely, the merger of a series of the Fund into or the consolidation of a series of the Fund with another investment company or series thereof, the sale by a series of the Fund of all, or substantially all, of its assets to another investment company or series thereof, or the liquidation or dissolution of a series of the Fund and distribution of its assets, upon the payment of the fees, disbursements and expenses of the Bank through the then remaining term of this Agreement, the Bank will complete all actions reasonably necessary to implement such merger, consolidation, or sale upon the order of the Fund set forth in an Officers' Certificate, accompanied by a certified copy of a resolution of the Board authorizing any of the foregoing transactions. Upon completion of such actions and the payment of all such fees, disbursements and expenses of the Bank, this Agreement will terminate and the Bank shall be released from any and all obligations hereunder.

* * * * *

HARRIS ASSOCIATES INVESTMENT TRUST

BY: /s/ KRISTI L. ROWSELL

Name: Kristi L. Rowsell
Title: Treasurer

INVESTORS BANK & TRUST COMPANY

BY: /s/ MICHAEL F. ROGERS

Name: Michael F. Rogers
Title: President

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed Oct. 10, 2006]

DEFENDANT HARRIS ASSOCIATES L.P.'S RESPONSE TO PLAINTIFFS' STATEMENT OF UNDISPUTED MATERIAL FACTS PURSUANT TO LOCAL RULE 56.1

1. The named Plaintiffs are Jerry N. Jones, Mary Frances Jones, and Arline Winerman. The Defendant is Harris Associates L.P.

Response: Undisputed.

2. Jerry N. Jones and Mary Frances Jones are residents of Columbia, Missouri. At the time the Complaint was filed, Mr. and Mrs. Jones jointly owned shares in the Oakmark Equity and Income Fund and the Oakmark Global Fund. They have owned shares in the Oakmark Equity and Income Fund since December 22, 2003, and have held those shares throughout the relevant period. They have owned shares in the Oakmark Global Fund since

March 12, 2004, and have held those shares throughout the relevant period.

Response: Undisputed.

3. Arline Winerman is a resident of St. Petersburg, Florida. At the time the Complaint was filed, Ms. Winerman owned shares in the Oakmark Fund. She has owned shares in the Oakmark Fund since December 10, 2003, and has held those shares throughout the relevant period.

Response: Undisputed.

4. The Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund (the "Funds") are separate operating series of the Harris Associates Investment Trust, a Massachusetts business trust that is registered with the Securities and Exchange Commission under the Investment Company Act of 1940 ("ICA") as an open-end management investment company.

Response: Undisputed.

5. Harris Associates L.P. ("HALP") is a Delaware limited partnership that is registered as an investment adviser under the Investment Advisers Act of 1940. HALP is the investment adviser to each of the Funds.

Response: Undisputed.

6. Harris Associates, Inc. ("HAI") is the general corporate partner of HALP (collectively with HAI, "Harris"). HAI manages HALP through a board of directors.

Response: Undisputed.

7. Each of the Funds pays HALP a monthly investment advisory fee based on each Fund's net assets at the end of the preceding month. For the fiscal year ended September 30, 2003, HALP charged the

Funds over $63 million in investment advisory fees, and for the fiscal year ended September 30, 2004, HALP charged the Funds over $109 million in investment advisory fees. The investment advisory fees paid during these periods were approved by the Funds' Board of Trustees at meetings held October 16, 2002, and October 21, 2003.

Response: Harris disputes this statement to the extent it suggests that the trustees approved the total level of fees for each year. In fact, the trustees approved, at the start of each fiscal year, the renewal of the investment advisory contract and a fee schedule to be included therein. The total level of fees in any fiscal year is the result of the application of this approved fee schedule to the assets under management in each fund. *See* Pls.' Ex. D-2 at 6-7; Pls.' Ex. D-4 at 12-13. Otherwise the statement is undisputed.

8. This action is a derivative action brought by Plaintiffs on behalf of the Funds pursuant to § 36(b) of the Investment Company Act of 1940 ("ICA"), as amended, 15 U.S.C. §§ 80a-35(b).

Response: Undisputed.

9. This Court has subject matter jurisdiction pursuant to 15 U.S.C. § 80a-43, 15 U.S.C. § 80a-35(b)(5), and 28 U.S.C. § 1331.

Response: Undisputed.

10. Venue is proper in this judicial district pursuant to 15 U.S.C. § 80a-43 and 28 U.S.C. § 1391(b). Defendant's principal place of business is Two North LaSalle Street, Suite 500, Chicago, Illinois 60602. Accordingly, Defendant is an inhabitant of this district, transacts business in this district, resides in this district, and may be found in this district. In addition, a

substantial part of the events or omissions that give rise to Plaintiffs' claims occurred in this district.

Response: Undisputed.

11. From January 1, 2001 to July 16, 2003, the Board of Trustees for the Funds was comprised of eight "disinterested" trustees and one "interested" trustee. The disinterested trustees were: Victor Morgenstern (Chairman), Gary N. Wilner, Burton W. Ruder, Mary R. Rotter, Michael J. Friduss, Allan J. Reich, Thomas H. Hayden, and Christine M. Maki. The interested trustee was Peter S. Voss, President and CEO of Harris' parent company. On July 16, 2003, John Raitt, President and CEO of Harris, was added as an interested trustee. This composition remained in place until Victor Morgenstern resigned as a disinterested trustee effective January 1, 2005.

Response: Undisputed.

12. The Board of Trustees is responsible for approving the investment advisory fees on an annual basis. During the period January 1, 2001 to January 1, 2005, the Board of Trustees had an Executive Committee, a Governance Committee, and a Management Contracts Committee. The Executive Committee generally has the authority to exercise the powers of the Board of Trustees during intervals between meetings. The principal functions of the Governance Committee was to make recommendations to the board regarding board committees and committee assignments, the composition of the board, candidates for election as non-interested trustees and compensation of non-interested trustees, and to oversee the process for evaluating the functioning of the board. The principal functions of the Management Contracts Committee was to review, and make recommendations to the board regarding, investment

advisory agreements and any other agreements relating to the management or administration of the funds.

Response: Undisputed.

13. Morgenstern became an interested trustee of the Funds in 1991. Prior to January 1, 2001, Morgenstern was a partner at HALP and Chairman of the board of directors of HAI. Effective January 1, 2001, Morgenstern retired from Harris and became a "disinterested" trustee of the Funds as well as Chairman of the Board. Morgenstern began receiving compensation as a disinterested trustee, as well as an additional $50,000 per year for serving as Chairman, and was appointed to the Executive Committee (as chair), Governance Committee, and Management Contract Committee as a disinterested trustee. On November 9, 2004, Morgenstern resigned his position as an independent trustee effective January 1, 2005.

Response: Undisputed, except that Mr. Morgenstern was not a legal partner at Harris (which is not a partnership). Prior to his retirement, he was an employee. Harris disputes this characterization of Harris employees as "partners" each time it appears below.

14. Wilner has been an independent trustee of the Funds since 1993 and became chairman sometime after Morgenstern's resignation. He has been a member of the Executive and Governance Committees since 2001 and served as chairman of the Governance Committee in 2004.

Response: Harris does not dispute that Wilner served as Chairman of the Governance Committee. However, Wilner served as Chairman of the Governance Committee during the fiscal year ended Sep-

tember 30, 2003. He did not serve in this position during any portion of calendar year 2004. *See* Pls.' Ex. C-4 at 28.

15. Ruder has been an independent trustee of the Funds since 1995. He has been a member of the Governance and Management Contracts Committees since 2001 and served as Committee chairman from 2001 to 2003.

Response: Harris does not dispute that Ruder served as chairman of the Governance Committee. However, Ruder served as Chairman of the Governance Committee during the fiscal years ended September 30, 2001 and September 30, 2002. Ruder did not serve in this position during any portion of calendar year 2003. Ruder did not serve as Chairman of the Management Contracts Committee. *See* Pls. Ex. C-3 at 26; Pls.' Ex C-4 at 28.

16. Rotter has been an independent trustee of the Funds since 1996. He has been a member of the Management Contracts Committee since 2001.

Response: Undisputed.

17. Reich has been an independent trustee of the Funds since 1993. He has been a member of the Governance Committee since 2001.

Response: Undisputed.

18. Friduss has been an independent trustee of the Funds since 1995. He was a member of the Management Contracts Committee from 2001 to 2004, serving as Committee chairman from 2001 to 2002, and became a member of the Governance Committee in 2004.

Response: Harris does not dispute that Friduss served as Chairman of the Management Contracts Committee. However, Friduss served in this position

during the fiscal years ended September 30, 2001 and September 30, 2002. *See* Pls.' Ex. C-3 at 26; Pls.' Ex. C-4 at 28. Harris does not dispute that Friduss served as a member of the Governance Committee. However, Friduss joined this committee in 2003.

19. Hayden has been an independent trustee of the Funds since 1995. He has been a member of the Management Contracts Committee since 2001 and became Committee chairman in 2004.

Response: Harris does not dispute that Hayden served as Chairman of the Management Contracts Committee. However, he began serving in this position during the fiscal year ended September 30, 2003, and thus became chairman in calendar year 2002.

20. Maki has been an independent trustee of the Funds since 1996. She was a member of the Governance Committee from 2001 to 2004 and became a member of the Executive Committee in 2004.

Response: Undisputed.

21. After resigning from Harris on January 1, 2001, and becoming a trustee of the Funds, Morgenstern became entitled to receive deferred compensation from Harris pursuant to what is called the "C' Compensation Plan ("C Plan").

Response: Undisputed.

22. Morgenstern's C Plan payments were based on compensation he had previously received in connection with his ownership of "C units" in Harris. While the total amount of C Plan compensation was potentially fixed and was to be paid over six years, the actual payments could be reduced each year based on certain limits associated with HALP's revenues. The reductions could be made up in subsequent years if there were sufficient revenues, but any reductions

not made up within four years after the expiration of the sixth year (for a total period of ten years) would be forfeited. Consequently, payments to deferred payees under the C plan can be reduced, and ultimately forfeited, as a function of HALP's revenues, which revenues are derived in large measure from the investment advisory fees paid to HALP by the Funds.

Response: Harris disputes the statement that HALP's revenues are derived in "large measure" from investment advisory fees paid by the Funds. Indeed, for the year ended December 31, 2003, Harris received revenue of approximately $145 million from advisory fees paid by the Oakmark family of funds. Of this amount, approximately $72 million, or less than half of the total amount of advisory fees paid by the Oakmark family of funds, represented advisory fees paid by the Funds at issue in this suit. Additionally, Harris receives, as revenue, advisory fees from the individual, institutional and sub-advised accounts to which it provides advisory services. Advisory fees from the Funds are therefore significantly less than half of HALP's revenues. It is therefore inaccurate to state that HALP's revenues are derived "in large measure" from advisory fees paid by the Funds. *See* Responses to Information Request of the Management Contracts Committee, dated May 2004 ("Mgmt. Contracts Request"), attached as Ex. 8 to Decl. of Brian R. Blais, dated Oct. 10, 2006 ("Oct. Blais Decl."), at HA 0000459. The statement is otherwise undisputed.

23. The targeted amount of Morgenstern's C Plan compensation was $632,125. However, in 2001 (his first year of eligibility for deferred C Plan compensation) Morgenstern received only $585,310 because

HALP's revenues in 2001 were not sufficient to entitle him to the entire $632,125.

Response: Undisputed.

24. The amount of funds available for distributions from the C Plan included revenues from Harris Alternatives, which at one time was an operating unit within HALP that managed funds of hedge funds, but was spun off as a separate entity in 2003.

Response: Undisputed.

25. Other participants in the C Plan who received deferred payments while Morgenstern was a trustee for the Funds include Anita Nagler, Roxanne Martino, and Anita Rosenberg, all of whom left Harris in the spin off of Harris Alternatives, and Sherwin Zuckerman.

Response: Harris does not dispute that Nagler and Martino received deferred compensation payments under the C Plan for a portion of the time that Morgenstern was a disinterested trustee of the fund, but disputes that this was the case for the entirety of Morgenstern's board service. Rosenberg did not receive deferred compensation payments under the C Plan.

26. Morgenstern, Wilner, and Ruder have been neighbors in Highland Park and have socialized for many years. They have children who are contemporaries. Morgenstern and Wilner are close friends and have vacationed together for 20 years. Morgenstern and Ruder often talk or meet weekly and have also vacationed together, including at property owned by Morgenstern and Wilner and a trip to Israel for Ruder's son's bar mitzvah about 11 years ago.

Response: Harris disputes Plaintiffs' assertion that Morgenstern and Ruder "often talk or meet

weekly" on the grounds that there is no basis to conclude that such talks or meetings occurred "often." Mr. Ruder stated in his deposition that he sees Mr. Morgenstern "sometimes once a week, sometimes twice a week, sometimes I don't see him for two, three weeks." *See* Pls. Ex. E-4 at 30. The statement is otherwise undisputed.

27. Approximately 10 years ago, while Morgenstern was still a partner at Harris and Wilner was a trustee of the Funds, Morgenstern and Wilner formed a partnership called Bear East Partners. Bear East Partners invested in, among other things, Endologix and Tekelec, in which Morgenstern believed current and former Harris partners may also have invested. Prior to substantially liquidating the partnership in 2005, it was worth approximately $200,000. Bear East Partners' trades were sent through Harris.

Response: Undisputed.

28. In addition to the entities detailed below (Bio-Sante and Valor Equity Partners), Morgenstern and Wilner have invested together in real estate. While Morgenstern was still a partner at Harris and Wilner was a trustee of the Funds, they sold property they owned together (with a third person) to a then-partner of Morgenstern at Harris, Robert Sanborn. They originally bought the property for approximately $600,000 and sold it to Sanborn in February of 1999 for $2.25 million. They made "a very nice profit" according to Wilner. Morgenstern and Wilner have also owned vacation property together in Steamboat Springs, Colorado, for 16 or 17 years. This property is worth approximately $1 million.

Response: Undisputed.

29. Wilner is involved as a trustee or potential substitute trustee for one of Morgenstern's family trusts.

Response: Undisputed.

30. In addition to the entities detailed below (BioSante and Valor Equity Partners), Ruder has invested with Morgenstern in entity called Super Cerca, which Morgenstern introduced to Ruder.

Response: Undisputed.

31. Morgenstern has also been friends with Friduss since 1960. They attended college together at Illinois Institute of Technology, and they now live near one another. Friduss' brother, Jarvis, was Morgenstern's personal accountant for several years.

Response: Undisputed.

32. In 1993 and 1995, Morgenstern recommended Wilner, Ruder, and Friduss as "disinterested" trustees of the Funds. They were selected as trustees by the partners at Harris.

Response: Harris disputes that Wilner, Ruder and Friduss were "selected as trustees" by the senior Harris employees referred to as "partners." The Trustees were elected by the board of trustees and subsequently elected by the shareholders of the Funds.

33. Sherwin Zuckerman is a close friend and former partner of Morgenstern at Harris. Zuckerman serves as a trustee of Morgenstern's family trusts. In addition to the entities detailed below (BioSante and Valor Equity Partners), Morgenstern and Zuckerman have numerous common investments, including Hesperus Partners, the Harris Glencoe Partnership, a series of the Walton Street Real Estate Fund, and

Constable Partners. Zuckerman retired from Harris a year after Morgenstern.

Response: Undisputed.

34. After Morgenstern retired from Harris, he continued to serve as a trustee of a personal trust for Earl Rusnak, a partner at Harris. Rusnak retired from Harris approximately 3 years after Morgenstern retired.

Response: Undisputed.

35. Morgenstern is a trustee of the Illinois Institute of Technology along with two former partners of his at Harris, Anita Nagler and Ralph Wanger.

Response: Undisputed.

36. Morgenstern invested in a number of investment vehicles and private equity funds in addition to those described above and those detailed below (BioSante and Valor Equity Partners) that may have had investors who were current or former partners of Harris or current or former trustees of the Funds, but he did not know or could not recall. For instance, Morgenstern recalled that he and Bob Levy (current Harris partner) invested together in Sonoma Lodge and that he and Peter Foreman (former Harris partner) invested together in Austin/Churchill Forge Properties and Northbrook Partners.

Response: Undisputed.

37. Morgenstern was a director and substantial shareholder in a company called BioSante Pharmaceuticals beginning in the late 1990s. Morgenstern became a director of BioSante in July 1999 as a representative of Starbow Investors in connection with a May 1999 private placement. At the time, BioSante was a privately held, unlisted penny-stock small business company. In 1999, 51.1% of BioSante's

common stock was owned by 10 of its directors and officers and it had approximately 1,600 shareholders.

Response: Undisputed.

38. Morgenstern has over $2 million invested in BioSante. Other investors in BioSante included at least two of Morgenstern's partners at Harris (Zuckerman and Anita Nagler) and three of the disinterested trustees for the Funds (Wilner, who invested $50,000 in 1999 – now worth $141,000; Ruder, who invested $50,000 in 1999 for family members and currently owns additional stock through a partnership he manages; and Rotter, who has owned BioSante stock since 2001 – currently worth at least $75,000 – through a family partnership). These persons learned about BioSante from Morgenstern while he was at Harris.

Response: Undisputed.

39. Jarvis Friduss also owns stock in BioSante.

Response: Undisputed.

40. In 2002 Morgenstern founded Valor, a private equity investment partnership that attracted about 30 investors. Morgenstern has invested over $2 million in Valor on an on call basis and has paid in over $1 million. Three partners at Harris (Nagler, Roxanne Martino and Anita Rosenberg) and one former partner (Zuckerman, in the amount of $550,000) have invested in Valor. Three disinterested trustees of the Funds have also invested in Valor, including Wilner and Ruder, who have each invested $125,000 on an on call basis and have paid in about $70,000 and $50,000, respectively, and Rotter, who has invested $500,000 on an on call basis and has paid in about $275,000. All of these co-investors were invited into Valor by Morgenstern.

Response: Undisputed.

41. Morgenstern's son is employed by Valor.

Response: Undisputed.

42. Morgenstern has invested millions of dollars in the following investment products: Aurora, L.P., Stellar, L.P., Perseus, L.P., Pleiades Offshore Fund Limited, and Aurora Offshore Fund Limited. These are hedge funds managed by Harris Alternatives, which was previously known as Harris Partners and is an affiliate of HALP. After Morgenstern retired from Harris, he continued to receive a discount on the fees he paid on Harris Alternatives investment vehicles. Harris Alternatives generated revenues that were included in the "C pool" from which Morgenstern's compensation from Harris was paid while he was an independent trustee.

Response: Undisputed.

43. Wilner has invested in SPA Partners L.P., an investment product managed by Harris Alternatives.

Response: Undisputed.

44. Rotter has invested in the Aurora Offshore Fund Limited, a hedge fund managed by Harris Alternatives and in which he believes Harris partners have invested.

Response: Undisputed.

45. Rotter and Zuckerman have been friends for 20 years. Rotter was a client of Zuckerman, and Zuckerman is married to Rotter's cousin. Rotter has shared in the following investments with Zuckerman: Valor, Walton Street, BioSante, and G-Tess. With regard to Walton Street, Zuckerman committed $1 million and Rotter committed $750K. Clyde McGregor, a Harris partner managed Rotter's $7-million account after Zuckerman retired from Harris

and until Rotter moved his account back to Zuckerman after the expiration of a non-complete agreement between Zuckerman and Harris. Rotter was an advisory client of Harris's before he became a disinterested trustee, and was a neighbor, with children who were contemporaries, of Morgenstern's. Rotter came to be a trustee by way of an introduction by Zuckerman.

Response: Undisputed.

46. Reich has provided legal representation to persons affiliated with Wanger Asset Management, the founder of which had been a Harris partner, and once represented Robert Levy, a Harris partner, in a commercial dispute. Reich knew Levy, Zuckerman and Szold before he became a trustee. Reich socialized with Levy, Reich's and Zuckerman's children schooled together, and Szold was Reich's father's broker. Reich has an IRA at Harris that is managed by Levy, and Levy recommended Reich for the Board of Trustees.

Response: Undisputed.

47. Ruder had an account with Harris more than five years ago through which he bought stocks.

Response: Undisputed.

48. Morgenstern participated in the independent trustees' evaluation of the advisory contracts and voted on the contracts from 2001 through 2004.

Response: Undisputed.

49. When the Governance Committee evaluated Morgenstern's performance as chairman at the October 21, 2003 meeting, they approved his performance in part because he had "severed all his formal and financial ties to the advisor and was truly independent." See Minutes of Meeting of the Governance

Committee of the Board of Trustees, October 21, 2003 (HAl28740) [attached as Exhibit D-24], at p. 4. However, at least some of the independent directors knew this was not true. Wilner knew in 2003 through 2005, if not prior to that as well, that Harris was compensating Morgenstern at a time when Morgenstern was an independent director. Ruder and Reich were also aware that Morgenstern received compensation from Harris after Morgenstern became an independent director. Nonetheless, Wilner did not know how Morgenstern's compensation was calculated or whether it was based on Harris's revenues or profits, although he believed it would terminate if Harris ceased to exist. Nor was Ruder aware that Morgenstern's compensation could be affected by the amount of Harris's revenues. On the other hand, Friduss knew that Morgenstern received compensation and that it "was related in some way to the financial success that Harris had in a given year" and that there was a connection between the amount of the fees the directors negotiated and the amount of Morgenstern's compensation. However, Friduss did not believe that this created even an appearance of a conflict.

Response: Harris disputes that the quoted statement from the October 21, 2003 minutes was "not true" and/or that the independent trustees "knew" or believed it to be untrue. Harris further disputes this statement to the extent it states that Friduss "knew" that there was a connection between the amount of the fees the directors negotiated and the amount of Morgenstern's compensation. Mr. Friduss stated, in his deposition, that he "supposed" there was a connection, not that he "knew" there was such a connection. *See* Pls.' Ex E-5 at 49.

50. Rotter and Reich were aware of Wilner's and Morgenstern's joint real estate investments in Colorado and Wisconsin, and Ruder was aware of the joint investment in Colorado. Rotter was aware that Morgenstern was invested in Valor. Wilner knew that Ruder was also a Valor investor and that Zuckerman had some relation to Valor and that Ruder might also be an investor in BioSante. Morgenstern was aware, of course, of his own joint investments with Wilner, Ruder, and Rotter and various Harris Partners. There is no evidence in the Record that the independent directors who might have been expected to investigate the more serious conflicts of their colleagues actually did so. Friduss stated that the independent directors made a determination regarding their independence "in a formal way . . . through a questionnaire" but conceded that the board left it to independent counsel to review the questionnaires and report to the board if there were any problems.

Response: Undisputed.

51. Morgenstern's C-Plan compensation from Harris was never disclosed in the registration statements for the Funds.

Response: Undisputed.

52. The investments by Morgenstern, Wilner, and Rotter in investment products managed by Harris Alternatives were never disclosed in the registration statements for the Funds.

Response: Undisputed.

53. Harris executives attended virtually all of the meetings of the Management Contracts Committee.

Response: Undisputed.

54. Harris executives attended virtually all of the meetings of the Governance Committee.

Response: Undisputed.

55. The independent trustees occasionally met in executive session, but this was rare. The executives actively participated in most meetings.

Response: Harris disputes that Plaintiffs' citation to the minutes of a single meeting during which the trustees met in executive session supports the conclusion that these executive sessions occurred "occasionally" or "rarely."

STATEMENT OF ADDITIONAL FACTS

Harris submits the following additional facts which support the denial of summary judgment for Plaintiffs and the granting of Harris's motion for summary judgment.

1. For its service as investment adviser, Harris receives a fee from each Fund, calculated as a percentage of that Fund's net assets at the end of the preceding month. *See* The Oakmark Family of Funds Statement of Additional Information, dated Jan. 31, 2004 ("2004 SAI"), attached as Ex. 2 to Decl. of Brian R. Blais, dated Sept. 12, 2006 ("Sept. Blais Decl."), at HA 0112536.

2. The fee schedule for the Funds is set forth as part of the advisory contract for each Fund and is negotiated and approved each year by the trustees. *See* 2004 SAI at HA 0112536- HA 0112537 (Ex. 2 to Sept. Blais Decl.).

3. The fee schedule for each of the Funds features "breakpoints," *i.e.*, asset levels at which the fee declines. *See* 2004 SAI at HA 0112536 – HA 0112537 (Ex. 2 to Sept. Blais Decl.); The Oakmark Family of Funds Statement of Additional Information, dated Jan. 28, 2005 ("2005 SAI") at 17-20 (Ex. 3 to Sept. Blais Decl.).

4. In recent years, the annual contract renewal process resulted in the initiation of additional breakpoints in the fee schedules of the Funds. *See* Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated Aug. 25, 2003 ("August 25, 2003 Committee Minutes") at HA 0002884 – HA 0002890 (Ex. 5 to Sept. Blais Decl.).

5. The following table summarizes the fee schedule for each of the Funds, as negotiated and approved by the trustees, including the additional breakpoints negotiated and approved by the trustees during 2003 and 2004:

The Oakmark Fund	Equity & Income Fund
First $2.0 billion under mgmt: 1.00%	First $5.0 billion under mgmt: 0.75%
Next $1.0 billion under mgmt: 0.90%	Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2003)*
Next $2.0 billion under mgmt: 0.80%	Next $2.5 billion under mgmt: 0.675% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.75%	Next $2.5 billion under mgmt: 0.65% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2004)*	
Net assets over $10 billion 0.65% *(New breakpoint as of 11/1/2004)*	Net assets in excess of $12.5 billion: 0.60% *(New breakpoint as of 11/1/2004)*

Global Fund
First $2.0 billion under mgmt: 1.00%
Next $2.0 billion under mgmt: 0.95% *(New breakpoint as of 11/1/2003)*
Net assets in excess of $4 billion: 0.90% *(New breakpoint as of 11/1/2003)*

6. The annual process of negotiating and approving Harris' advisory contract and fees pursuant to Section 15(c) of the ICA spans several months and involves multiple meetings between Harris and certain of the trustees. *See* Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated May 1, 2002 ("May 1, 2002 Committee Minutes"), at HA 0005315 – HA 0005318; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated May 14, 2002 ("May 14, 2002 Committee Minutes"), at HA 0005319 – HA 0005322; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated June 25, 2002 ("June 25, 2002 Committee Minutes"), at HA 0005056 – HA 0005059; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated July 12, 2002 ("July 12, 2002 Committee Minutes"), at HA 0005061 – HA 0005066; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated Sept. 11, 2002 ("September 11, 2002 Committee Minutes"), at HA 0005067 – HA 0005069; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated Apr. 16, 2003 ("April

16, 2003 Committee Minutes"), at HA 0002844 – HA 0002849; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated June 6, 2003 ("June 6, 2003 Committee Minutes"), at HA 0002850 – HA 0002856; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated June 24, 2003 ("June 24, 2003 Committee Minutes"), at HA 0002857 – HA 0002861; August 25, 2003 Committee Minutes at HA 0002884 – HA 0002890; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated Feb. 17, 2004 ("February 17, 2004 Committee Minutes"), at HA 0002927 – HA 0002933; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated May 25, 2004 ("May 25, 2004 Committee Minutes"), at HA 0002951 – HA 0002957; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated June 2, 2004 ("June 2, 2004 Committee Minutes"), at HA 0002958 – HA 0002966; Minutes of the Meeting of the Committee on Management Contracts of the HAIT Board of Trustees, dated July 20, 2004 ("July 20, 2004 Committee Minutes"), at HA 0002967 – HA 0002974. Minutes of the Meetings of the Committee on Management Contracts during 2002 are collected as Ex. 4 to Sept. Blais Decl. Minutes of the Meetings of the Committee on Management Contracts during 2003 are collected as Ex. 5 to Sept. Blais Decl. Minutes of the Meetings of the Committee on Management Contracts during 2004 are collected as Ex. 6 to Sept. Blais Decl.

7. Much of the trustees' information-gathering and analysis undertaken pursuant to Section 15(c) of the ICA is completed by a Management Contracts

Committee of the board, which then makes a recommendation to the full board for consideration. The Management Contracts Committee met five times over the course of five months in 2002, four times over the course of five months in 2003, and four times over the course of the six months prior to the filing of the complaint in this action in August 2004. *See* sources cited in ¶ 6 of Stmt. of Additional Facts, *supra*.

8. The trustees are advised throughout this process by independent, outside counsel from the firm of Bell Boyd & Lloyd. *See* sources cited in ¶ 6 of Stmt. of Additional Facts, *supra*.

9. Each year, Harris provides to the trustees at their request information on a variety of topics: the services provided by Harris to the Funds in exchange for the fees; the Harris personnel providing those services; the investment performance of the Funds; the profitability of the advisory contracts to Harris, including detailed information about Harris expenses; certain transactions between the Funds and entities affiliated with Harris (*e.g.*, Harris' affiliated broker); benefits accruing to Harris in addition to fees (*e.g.*, use of "soft dollars" to offset the cost of research services); and compliance information, including information about the best execution of portfolio transactions for each Fund, allocation of purchase and sale transactions among broker-dealers and compliance with the Funds' investment restrictions. *See* Responses to Information Request of the Management Contracts Committee, dated May 2004 ("Mgmt. Contracts Request") at HA 0000213 – 0000217 (Ex. 1 to Sept. Blais Decl); Dep. Tr. of Thomas H. Hayden ("Hayden Dep.") at 48-52 (Ex. 9 to Sept. Blais Decl.).

10. The trustees also commission a third-party industry consultant known as Lipper to provide certain requested data. These materials include comparisons of the Oakmark Funds' investment performance, fees, and profitability to those of a peer group of the Funds' competitors. *See* May 14, 2002 Committee Minutes at HA 0005319 – HA 0005320 (Ex. 4 to Sept. Blais Decl.); June 25, 2002 Committee Minutes at HA 0005056 – HA 0005057 (Ex. 4 to Sept. Blais Decl.); April 16, 2003 Committee Minutes at HA 0002844 – HA 0002846 (Ex. 5 to Sept. Blais Decl.); June 6, 2003 Committee Minutes at HA 0002850 – HA 0002853 (Ex. 5 to Sept. Blais Decl.); May 25, 2004 Committee Minutes at HA 0002951 – HA 0002957 (Ex. 6 to Sept. Blais Decl.); Confidential Report to the Trustees prepared by Lipper, Inc., dated June 25, 2002 ("2002 Lipper Report") at HA 0082587 – HA 0082595 (Ex. 10 to Sept. Blais Decl.); Confidential Report to the Trustees prepared by Lipper, Inc., dated June 6, 2003 ("2003 Lipper Report") at HA 0081932 – HA 0081940 (Ex. 11 to Sept. Blais Decl.); Confidential Report to the Trustees prepared by Lipper, Inc., dated May 25, 2004 ("2004 Lipper Report") at HA 0001998 – HA 0002012; HA 0002095 – 0002110; HA 0002126 – HA 0002141 (Ex. 12 to Sept. Blais Decl.); Confidential Report to the Trustees prepared by Lipper, Inc., dated May, 2004 ("2004 Supplemental Lipper Report") at HA 0089095 – HA 0089110 (Ex. 13 to Sept. Blais Decl). The investment performance figures in the Lipper materials are reported net of the advisers' fees. *See* 2004 Lipper Report at HA 0002225 (Ex. 12 to Sept. Blais Decl.). The Lipper materials also present data on fees in isolation from the net performance figures. The 2004 Lipper report shows total expenses for each Fund as follows: Global Fund was 0.168% below the median for its peer group, the

Equity and Income Fund was 0.025% above the median for its peer group and the Oakmark Fund was 0.174% above the median for its peer group. *See* 2004 Lipper report at HA 0002099, HA 0002130 (Ex. 12 to Sept. Blais Decl.); 2004 Supplemental Lipper Report at HA 0089099 (Ex. 13 to Sept. Blais Decl.).

11. At the request of the trustees, the 15(c) materials also describe which of the services provided by Harris to the Funds are *not* provided to Harris' non-mutual fund clients. *See* Mgmt. Contracts Request at HA 0000327 – HA 0000331, HA 0000437 – HA 0000447 (Ex. 1 to Sept. Blais Decl.).

12. For the three year period ended March 31, 2004, the Oakmark Equity and Income Fund generated an average annual return of 12.49%, net of fees, the third best performance during that three year period of the 445 funds in its performance universe, as defined by Lipper, and above its benchmark, the Lipper Balanced Fund Index, which had an average annual return of 3.76%. For the five year period ending March 31, 2004, the Oakmark Equity and Income Fund's average annual net return of 13.91% was the single best performance result of any fund in its performance universe, and above its benchmark figure of 3.11%. *See* 2004 Lipper Report at HA 0002107 (Ex. 12 to Sept. Blais Decl.).

13. For the three year period ended March 31, 2004, the Oakmark Fund generated an average annual return of 6.22% net of fees, giving it a rank of 12 out of 307 funds in its Lipper performance universe, and placing it above its benchmark, the Lipper Large-Cap Value Index, which had an average annual return of 1.43%. For the five year period ended March 31, 2004, the fund's average annual net return was 5.29%, giving it a rank of 18 out of

224 funds in its performance universe, and above its benchmark figure of 1.22%. 2004 Supplemental Lipper Report at HA 0089107 (Ex. 13 to Sept. Blais Decl.).

14. For the three year period ended March 31, 2004, the Oakmark Global Fund generated an average annual return of 22.36%, net of fees, the single best performance result of any of the 254 funds in its performance universe, as defined by Lipper. This return was above its benchmark, the Lipper Global Fund Index, which had an average annual return of 2.31%. For the four year period ending March 31, 2004, the Oakmark Global Fund's average annual net return of 20.24% was the single best performance result of any fund in its performance universe, and above its benchmark, which had an average annual loss of 4.8%. *See* 2004 Lipper Report at HA 0002138 (Ex. 12 to Sept. Blais Decl.).

15. On January 17, 2001, Mr. Morgenstern explained to the other trustees that he would be stepping down as an executive of Harris, but wished to remain as chair of the board of trustees. The trustees were advised by their independent legal counsel that Mr. Morgenstern "would no longer fall within the statutory definition of 'interested' trustee unless the Securities and Exchange Commission, after an opportunity for a hearing, were to issue an order determining that Mr. Morgenstern prospectively would be an interested trustee by reason of having had a material business relationship with [Harris] . . . ." The trustees' counsel further advised that "[e]ven if Mr. Morgenstern were subsequently determined to be an interested trustee, that determination would not impair the validity of action taken by Mr. Morgenstern during the period that he was a non-interested

trustee. Moreover, even at the present time, the board has a super-majority (seven out of nine) non-interested trustees." The board unanimously approved Mr. Morgenstern's continued service as board chair. *See* Minutes of the Meeting of the HAIT Board of Trustees, dated Jan. 17, 2001, attached as Ex. 9 to Oct. Blais Decl., at HA 0010798 – HA 0010801.

16. During the Governance Committee meeting held on January 17, 2001, Mr. Morgenstern specifically disclosed that he would continue to receive deferred compensation from Harris in a fixed amount following his retirement: "Mr. Morgenstern informed the committee that he would not be entitled to any compensation from [Harris] for services rendered after January 31, 2001, although he expected to receive a fixed amount payout from [Harris] for his partnership interest to be paid in installments over the next several years." *See* Minutes of the Meeting of the HAIT Governance Committee, dated Jan. 17, 2001, attached as Ex. 10 to Oct. Blais Decl, at HA 0048258 – HA 0048260.

17. The other trustees periodically reviewed Mr. Morgenstern's performance as board chair. The October 21, 2003 minutes of the board's Governance Committee reflect that "each trustee offered accolades regarding Mr. Morgenstern's performance. . . . [T]he trustees also acknowledged that Mr. Morgenstern's previous experience with [Harris] provided additional insight into many aspects of [Harris's] operations. At the same time, the trustees agreed that Mr. Morgenstern has severed all his formal and financial ties to [Harris] and was truly independent." *See* Minutes of the Meeting of the HAIT Governance Committee, dated Oct. 21, 2003, attached as Ex. 11 to Oct. Blais Decl, at HA 0046654 – HA 0046655.

Respectfully submitted,

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Dated: October 10, 2006

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed Oct. 24, 2006]

PLAINTIFFS' REPLY TO DEFENDANT'S STATEMENT OF ADDITIONAL FACTS PURSUANT TO LOCAL RULE 56.1

1. For its service as investment adviser, Harris receives a fee from each Fund, calculated as a percentage of that Fund's net assets at the end of the preceding month.

REPLY: Admitted.

2. The fee schedule for the Funds is set forth as part of the advisory contract for each Fund and is negotiated and approved each year by the trustees.

REPLY: Denied. While the fees schedules for the Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund (collectively, the "Funds") are set forth in the advisory contracts for the Funds, the following factors (among others) establish that the fee

schedules were not negotiated at arm's-length or legally approved in compliance with the Investment Company Act of 1940 ("ICA"): (a) one of the supposedly disinterested trustee was in fact an interested person of Defendant Harris Associates L.P. ("Harris"); (b) a majority of the disinterested trustees suffered from numerous debilitating and disqualifying conflicts of interest because of personal and business relationships between the trustees and Harris; (c) Harris violated its fiduciary duty by failing to provide all necessary information for the trustees to make an informed decision regarding the fees paid by the Funds and, in some cases, by providing the trustees with false and misleading information; (d) Harris unduly dominated the trustees, thereby preventing them from fulfilling their fiduciary duties; and (e) Harris participated in schemes to extract additional monies from the Funds.

(a) Victor Morgenstern Was an Interested Trustee of Harris

Victor Morgenstern, Chairman of the Board of Trustees of the Funds, was supposedly disinterested and disclosed as such. *See* Plaintiffs' Statement of Undisputed Material Facts (Doc. No. 171) ("PSOF") ¶ 11. However, Morgenstern was in actuality an interested person of Harris (and therefore unqualified to serve as a disinterested trustee) because he received compensation from Harris that was tied to Harris's revenues, nearly one quarter of which were derived from fees paid by the Funds. *See* Harris Associates L.P. Net Revenue Analysis, December 31, 2003 (HA_N000000003.xls) [attached

as Exhibit C-41] (showing that the Funds accounted for 23.7% of Harris's total revenues).

Prior to January 1, 2001, Morgenstern was a partner and executive of Harris. Effective January 1, 2001, Morgenstern retired from Harris and became a "disinterested" trustee of the Funds as well as Chairman of the Board. *See* PSOF ¶ 13. At this time, Morgenstern began receiving "deferred" compensation from Harris ("C Plan Compensation") that was subject to reduction based on certain limits associated with Harris's revenues. *See* PSOF ¶¶ 21-22. For example, in 2001 (Morgenstern's first year of eligibility for C Plan Compensation) Morgenstern received less than his targeted amount because Harris's revenues in 2001 were not sufficient to entitle him to the entire $632,125. *See* PSOF ¶ 23. Other participants in the C Plan who received C Plan Compensation at some point while Morgenstern was a trustee for the Funds include Anita Nagler, Roxanne Martino, Anita Rosenberg, and Sherwin Zuckerman, all former partners of Morgenstern at Harris. *See* PSOF ¶¶ 24-25. Thus, Morgenstern had a direct economic incentive to approve higher fees for the Funds. *See generally* Declaration of Mercer Bullard [attached as Exhibit A-1], at Report ¶ 95; Declaration of Lyman Johnson [attached as Exhibit A-3], at Report at 14-16; Declaration of Tamar Frankel [attached as Exhibit A-2], at Report at 3-4.

Morgenstern's C-Plan compensation was never disclosed in the registration statements for the Funds. *See* PSOF ¶ 51.

(b) Trustee Conflicts of Interest

A majority of the disinterested trustees, including Morgenstern, suffered from numerous debilitating and disqualifying conflicts of interest because of personal and business relationships between the trustees and personnel at Harris. *See generally* PSOF ¶¶ 26-47.

Morgenstern, both while he was a partner at Harris and after he retired and became a "disinterested" trustee of the Funds, maintained very close personal and business relationships with other trustees of the Funds. Morgenstern, Wilner, and Ruder have been close friends and neighbors for many years. They have children who are contemporaries, they have vacationed together on many occasions, and Wilner is a trustee of one of Morgenstern's family trusts. *See* PSOF ¶ 26, 29. Morgenstern and Wilner formed an investment partnership called Bear East Partners approximately 10 years ago (worth about $200,000 when it was liquidated last year), which traded through Harris and may have invested in common vehicles with current and former Harris partners. *See* PSOF ¶ 27. Morgenstern and Wilner have also invested together in BioSante, Valor Equity Partners, and real estate, including vacation property in Colorado (worth about $1 million) and property in Wisconsin that they bought for $600,000 and sold in 1999 to a then-partner at Harris for $2.25 million. *See* PSOF ¶¶ 28, 37-38, 40. Morgenstern has invested together with Ruder in BioSante, Valor Equity Partners, and Super Cerca, which Morgenstern introduced to Ruder. *See* PSOF ¶¶ 30, 37-38, 40. Morgenstern has also been close friends with Friduss since

1960, and Friduss' brother, Jarvis, was Morgenstern's personal accountant for several years. *See* PSOF ¶¶ 31, 39. Morgenstern personally recommended Wilner, Ruder, and Friduss as "disinterested" trustees of the Funds. *See* PSOF ¶ 32; *see also* Bullard Report ¶¶ 97, 101, 105-10, 117 [Exhibit A-1]; Johnson Report at 14-15 [Exhibit A-3]; Frankel Report at 5 [Exhibit A-2].

After Morgenstern became a "disinterested" trustee, he also maintained close personal and business relationships with Harris. For example Morgenstern is a close friend of Sherwin Zuckerman (a former Harris partner who retired a year after Morgenstern) and has had numerous common investments with him, including, among others, BioSante and Valor Equity Partners. *See* PSOF ¶ 33. As detailed below, other Harris partners also invested in BioSante and Valor Equity Partners. In addition, Morgenstern has invested millions of dollars in (and received discounted fees on) hedge funds managed by Harris Alternatives (an affiliate of Harris), revenues of which contribute to the C Plan Compensation. *See* PSOF ¶ 42. These investments were never disclosed in the registration statements for the Funds. *See* PSOF ¶ 52.

Since the late 1990s, Morgenstern has been a director and substantial shareholder in a company called BioSante Pharmaceuticals, Inc. *See* PSOF ¶ 37. Morgenstern has over $2 million invested in BioSante. Others who invested in BioSante while Morgenstern was still a partner at Harris include at least two of his partners (Zuckerman and Anita Nagler – also C

Plan participants), three of the disinterested trustees for the Funds (Wilner, Ruder, and Rotter), and one trustee's brother, all of whom learned about BioSante from Morgenstern. *See* PSOF ¶¶ 38-39; *see also* Bullard Report ¶¶ 98, 102 [Exhibit A-1]; Frankel Report at 5 [Exhibit A-2].

In 2002 Morgenstern founded Valor Equity Partners, a private equity investment partnership that attracted about 30 investors. Morgenstern has invested over $2 million in Valor, and his son is employed by Valor. Three partners at Harris (Nagler, Roxanne Martino and Anita Rosenberg) and one former partner (Zuckerman) invested in Valor. Three disinterested trustees of the Funds (Wilner, Ruder, and Rotter) also invested in Valor. All of these co-investors were invited into Valor by Morgenstern. *See* PSOF ¶¶ 40-41; *see also* Bullard Report ¶ 96 [Exhibit A-1]; Johnson Report at 16 [Exhibit A-3]; Frankel Report at 4 [Exhibit A-2].

Other trustees with close personal and business relationships with Harris personnel include Rotter and Reich. Rotter has been friends with Zuckerman for 20 years, was (and is) a client of his, and Zuckerman is married to Rotter's cousin. Rotter and Zuckerman have invested together in numerous vehicles, including BioSante and Valor Equity Partners. Zuckerman recommended Rotter as a trustee of the Funds. Reich has provided legal representation for former and current Harris partners and has maintained a close relationship with Robert Levy (a Harris partner), who manages an IRA for Reich. Levy recommended Reich as a trustee of the Funds. *See* PSOF ¶¶ 45-46; *see*

also Bullard Report ¶¶ 112-13, 115 [Exhibit A-1]; Johnson Report at 16 [Exhibit A-3]; Frankel Report at 5-6 [Exhibit A-2].

(c) Harris Failed to Provide Necessary Information or Provided False and Misleading Information

Harris violated its fiduciary duty by failing to provide all necessary information for the trustees to make an informed decision regarding the fees paid by the Funds and, in some cases, by providing the trustees with false and misleading information.

(i) Profitability Information

The trustees of the Funds were unable to evaluate the profitability of the Funds to Harris because the information that Harris provided regarding the Funds' profitability was materially misleading and substantially misstated Harris's actual profitability. *See* Harris Associates L.P., Advisers' Profitability Analysis for Years Ended Dec. 31, 2000 to 2003 (HA0010619, HA0005070, HA0001835, HA0000458) [attached as Exhibit C-2]. This profitability information (1) allocated expenses in a manner that over-allocated expenses to large funds, under-allocated expenses to small funds, and masked economies of scale; (2) improperly treated profit sharing payments to the partners at Harris as an expense; (3) impermissibly included marketing expenses; and (4) lacked any outside verification of the methodology or data used and lacked adequate documentation. *See* Declaration of James D. Lamb [attached as Exhibit A-4], at Expert Report at 7-16 and Rebuttal Report at 1-4; Declaration of Steve

Pomerantz [attached as Exhibit A-6], at Expert Report 12-13, 14, 22; Bullard Report ¶¶ 167-77 [Exhibit A-1].

Harris allocates costs among its lines of business primarily based on headcount, assets and fund revenues. Harris then allocates the costs in each line of business (excluding marketing costs) among funds based on their percent of revenues. *See* Harris Associates L.P. Business Segment Revenue and Expense Determinations Terms Sheets, 2001 to 2003 (HA0143957, HA0143960, HA_S000008573) [attached as Exhibit C-21]; Workpapers (including handwritten notes) for Harris's 2003 Profitability Analysis (HA0009808) [attached as Exhibit C-17]; *see also* Lamb Report at 10-11 [Exhibit A-4]. Because all pre-marketing expenses are allocated by the percent of revenue each fund generates within its line of business, the pre-marketing profit ratios are identical for all funds within a business line (i.e. domestic and international – with global being a blend of both). *See, e.g.*, Harris Associates L.P., Advisers' Profitability Analysis for Year Ended Dec. 31, 2003 (HA0000458) at HA0000459 [Exhibit C-2] (showing pre-marketing profit margins for all domestic funds as 54.5%, all international funds as 50.2%, and the Global Fund – a blend of domestic and international – as 52.5%); Lamb Report at 11-12 [Exhibit A-4]; Lamb Rebuttal at 2 n.7 [Exhibit A-4]. Profitability results from such an allocation methodology do not accurately portray the consumption of shared expenses or reflect the true cost of activities required to operate a mutual fund. *See* Lamb Report at 10-12 [Exhibit A-4]; Pomerantz Report at 22 [Exhibit A-6]. For instance,

large, established funds are portrayed as requiring proportionately more investment management costs than smaller, less mature funds. *See* Lamb Report at 12 [Exhibit A-4]; Lamb Rebuttal at 2 [Exhibit A-4]; Pomerantz Report at 14 [Exhibit A–6]. This resulted in fund-by-fund economies of scale, as evidenced through increasing profit margins as assets grow, being hidden from the trustees for the Funds, rendering the profitability analyses misleading to the trustees. *See* Lamb Report at 9-16 [Exhibit A-4]; Pomerantz Report at 14 [Exhibit A-6]; Pomerantz Rebuttal at 4 [Exhibit A-6]; Bullard Report at ¶¶ 175 [Exhibit A-1].

In addition to the foregoing, Harris's profitability analyses treated the discretionary compensation payments to the partners of Harris as an expense. This component of Harris's "expenses" is substantial and amounted to 37% of Harris's total mutual fund revenues in both 2002 and 2003. *See, e.g.*, Harris Associates L.P., Advisers' Profitability Analysis for Year Ended Dec. 31, 2003 (HA0000458) at HA0000459 [Exhibit C-2]. However, the vast majority of these compensation payments represent additional profits of Harris and are made as profit-sharing payments. *See* Lamb Report at 13-16 [Exhibit A-4]; Lamb Rebuttal at 3-4 [Exhibit A-4] ("Those employees referred to as partners by HALP are paid a salary plus the remainder of revenues after all company expenses have been paid. The remainder of revenues after expenses have been paid is by definition "profit."); Pomerantz Report at 12-13, 22 [Exhibit A-6] ("Furthermore, the discretionary compensation, referred to above, is not an expense, but rather payments

made to partners and, as such, should more rightfully be viewed as an investment return. Simply speaking, it is profit."); Deposition of Michael Neary, July 20, 2005 [attached as Exhibit B-6], at 11-12 ("[T]here is economic benefit to being a partner in the sense of the profitability of the firm you get to share in, . . . kind of a typical profitability pool"); Deposition of John Raitt, Sept. 22, 2005 [attached as Exhibit B-8], at 201 ("[T]here [is] basically a day-to-day market level compensation level as well as some long-term equity ownership incentives, equity-like incentives available to the partners. . . . [T]here may be some ownership-type aspects to being a partner of the firm, and we recognize that."); Minutes of Meeting of Management Contracts Committee, June 6, 2003 (HA0002850) [attached as Exhibit C-9], at pp. 5-6 (Raitt stating that discretionary compensation "consists of a 'profit pool' that is divided among partners and paid out annually" and that Harris's compensation "reflects the benefits of equity ownership"); Board Materials (with executive handwritten notes) for Meeting of Management Contracts Committee, June 6 2003 (HA0001829-43) [attached as Exhibit C-10], at HA0001830 ("Each year the partners of Harris Associates essentially divide up the profits of the firm . . . . [P]artners 'own' the income stream . . . .").

The total compensation of the Harris partners (the vast majority of which – 94% – is made up of discretionary compensation) greatly exceeds the median compensation (including salary, bonuses, and non-cash compensation) in the industry for individuals with the same job responsibilities in similar asset management

firms. Total compensation for Harris partners in 2003 was $75 million, or over six times higher than the median figures. *See* Lamb Report at 14-15 [Exhibit A-4]; Lamb Rebuttal at 3-4 [Exhibit A-4]. The annual amounts of the discretionary compensation payments alone increased from $37.6 million in 2000 to $72.5 million in 2003, with individual payments to one partner exceeding $14 million in 2003 and $20 million in 2004 (over 17 times and 25 times the industry average of $793 thousand, respectively). *See* Pomerantz Report at 12-13 [Exhibit A-6]; Harris Associates L.P. Partner Compensation History (HA-N000000041) [attached as Exhibit C-30]; Deposition of William Nygren, Nov. 17, 2005 [attached as Exhibit B-7], at 58.

Including the discretionary compensation payments made to the partners of Harris as an expense when calculating the profitability of the Funds to Harris greatly misrepresented Harris's profitability to the trustees of the Funds. If the discretionary compensation payments were treated as profits for purposes of Harris's profitability analyses, Harris's pre-marketing profit margin in 2003 would have been 91% rather than 54%, as reported to the board. *See* Pomerantz Report at 22 [Exhibit A-6]; Harris Associates L.P., Advisers' Profitability Analysis for Year Ended Dec. 31, 2003 (HA0000458) at HA0000458 [Exhibit C-2]. Even if you factor in a reasonable amount of compensation for the partners based on median industry compensation, and treat the remainder as profits, Harris's 2003 pre-marketing profit margins for the Oakmark Fund and the Oakmark Equity and Income Fund would increase

from 54.5% to 86.4%, and its pre-marketing profit margins for the Oakmark Global Fund would increase from 52.5% to 78.9%. *See* Lamb Report at 16 [Exhibit A-4]. This does not even take into consideration Harris's flawed allocation methodology, which over-allocates costs to the larger funds. If Harris used an appropriate allocation methodology, the profit margins for the Oakmark Fund and the Oakmark Equity and Income Fund would have been even higher.

Harris's misrepresentation of the discretionary compensation as an expense influenced the trustees to believe Harris's profitability was lower than it really was. *See* Deposition of Marvin Rotter, Nov. 29, 2005 [attached as Exhibit B-10], at 155-56 (considering all of discretionary compensation to be an expense); Deposition of Burton Ruder, Sept. 26, 2005 [attached as Exhibit B-13], at 144-45. One trustee even stated that whether a given individual received money because it was a share of profits or discretionary compensation or base salary or draw wasn't necessarily important to us." Deposition of Victor Morgenstern, Sept. 23, 2005 [attached as Exhibit B-5], at 136. Moreover, while Harris attempted to justify the amount of compensation paid to the partners on the ground that the payments were necessary to be competitive in the industry so that Harris could retain investment professionals, the trustees had no basis to evaluate this justification because Harris never provided the trustees with the amounts of individual portfolio manager compensation. Accordingly, the trustees erroneously and baselessly believed that the compensation paid to the partners at

Harris was "in line with" industry norms. *See* Deposition of Thomas Hayden, Sept. 12, 2005 [attached as Exhibit B-3], at 135-36 (trustee did not know portfolio manager compensation or whether they were paid more or less than portfolio managers at other companies); Rotter Dep. at 154-58 [Exhibit B-10]; Ruder Dep. at 148-49 [Exhibit B-13] (trustees never received information regarding the amounts of compensation paid to individual partners or how it compared with the industry); Deposition of Gary Wilner, Sept. 13, 2005 [attached as Exhibit B-14], at 236-38 (trustee had no knowledge of Harris's portfolio manager compensation relative to the marketplace and did not know where to find that information). Even when the trustees asked for specific compensation information, Harris refused to provide it because of the supposed "complexity" of the issue and the compensation process. *See* Minutes of Meeting of Management Contracts Committee, Feb. 17, 2004 (HA020454) [attached as Exhibit C-11], at p.2.

In addition to Harris's improper allocations and treatment of profit-sharing payments as expenses, Harris included marketing expenditures in the profitability analyses given to the trustees of the Funds. *See, e.g.*, Harris Associates L.P., Advisers' Profitability Analysis for Years Ended Dec. 31, 2003 (HA0000458) at HA0000459 [Exhibit C-2] (containing line item for "Subsidiary Level Marketing" expenses). Prior to 2002, the profitability analyses showed fund-by-fund profitability margins only on a post-marketing basis. *See* Harris Associates L.P., Advisers' Profitability Analysis for Years

Ended Dec. 31, 2001 (HA0005070) at HA0005071 [Exhibit C-2]. Even after a line for the pre-marketing profit margin was added, however, the profitability analyses created the impression that the relevant profitability percentage for purposes of evaluating Harris's fund-by-fund profitability was the line titled "Profit Margin" (at the bottom of each page) as opposed to the pre-marketing profitability margin, which followed the line of expenses labeled "Subtotal" (implying that it was preliminary or incomplete). *See* Harris Associates L.P., Advisers' Profitability Analysis for Year Ended Dec. 31, 2003 (HA0000458) at HA0000459 [Exhibit C-2].

At least two trustees admitted that they considered marketing costs as an expense for purposes of evaluating Harris's profitability. *See* Deposition of Michael Friduss, Sept. 1, 2005 [attached as Exhibit B-2], at 148-49; Hayden Dep. at 201-05 [Exhibit B-3]. Harris executives, and even the trustees' own counsel, repeatedly reinforced the independent directors' consideration of marketing expenses (specifically intermediary payments) in face-to-face meetings with the trustees. *See, e.g.*, Minutes of Meeting of Management Contracts Committee, June 25, 2002 (HA0005056) [attached as Exhibit C-7], at p. 3 (Rowsell explaining that payments made to intermediaries caused Harris's profit margin for the Equity and Income Fund to be "substantially lower than its profit margin for the other funds"); Minutes of Meeting of Management Contracts Committee, July 12, 2002 (HA0005061) [attached as Exhibit C-8], at p. 2 (Cameron Avery, counsel for the trustees, noting that Harris's post-marketing profitability had declined over

the past three years, and Rowsell adding that "marketing expenses had steadily increased").

Finally, the methodology behind the profitability analyses Harris provided to the trustees lacked sufficient documentation and was not independently verified. Nor were the terms sheets and workpapers associated with the profitability analyses shared with the trustees. *See* Lamb Report at 12 [Exhibit A-4]; Deposition of Kristi Rowsell, June 15, 2005 [attached as Exhibit B-11], at 140. Furthermore, the trustees decided not to obtain an objective evaluation of the profitability analyses. *See* Minutes of Meeting of Management Contracts Committee, May 1, 2002 (HA0005315) [attached as Exhibit C-6], at HA0005317.

(ii) Economies of Scale

Harris prevented the trustees of the Funds from taking economies of scale into consideration when evaluating the Funds' advisory contracts because Harris failed to provide the trustees with adequate information regarding its economies of scale. In fact, Harris never provided the trustee with an actual economies-of-scale analysis. *See* Rowsell Dep. at 236-38 [Exhibit B-11]. Furthermore, the information Harris provided to the trustees regarding its profitability from managing the Funds was misleading, particularly because Harris's methodology for allocating its costs tended to mask the economies of scale inherent in Harris's business. *See* Pomerantz Report at 14 [Exhibit A-6].

(iii) Breakpoints

While the fee schedules for the Funds contain breakpoints (mostly nominal), the breakpoints in the fee schedules for institutional and sub-advisory clients are set at much lower asset levels, thus providing higher discounts to those clients. *Compare* Def.'s Statement of Additional Facts ("DSAF") ¶ 5 *with* Institutional Account Data (HA0135007-12, HA0135013X-27X, HA0135028A) [attached as Exhibit C-20] *and* Harris Associates Investment Trust, Responses to Information Request, May 2004 (HA0000211) [attached as Exhibit C-1], at Item D.2 (HA0000437-55); *see also* Lamb Report at 20 [Exhibit A-4]. The small breakpoints for the Funds were unrelated to actual economies of scale realized by Harris and were set by the trustees without reference to Harris's profitability or costs of providing services. *See* Friduss Dep. at 183-84 [Exhibit B-2] ("We don't scientifically know exactly what we're doing when we put those breakpoints in."); *see also* Lamb Report at 20 [Exhibit A-4]. Rather, the trustees looked to irrelevant factors, such as the placement of breakpoints by other mutual fund complexes. *See* Rotter Dep. at 98-100, 103 [Exhibit B-10]. In fact, one trustee even conceded that when it came to setting breakpoints, the trustees would have no idea whether breakpoints were set too high to pass on economies of scale. *See* Friduss Dep. at 184 [Exhibit B-2]. *See generally* Pls.' Reply to DSAF ¶¶ 3-5, *infra*, (discussing breakpoints for the Funds).

(iv) Harris's Institutional Clients

The advisory services Harris provides to its non-mutual fund clients are virtually identical to the advisory services Harris provides to the Funds. *See* Pls.' Reply to DSAF ¶ 11, *infra*. In fact, the cost to Harris in providing advisory services to its non-mutual fund accounts is actually greater than the cost of providing services to the Funds. *See* Pls.' Reply to DSAF ¶ 11, *infra*. The materials given to the trustees fail to provide this information and are false and misleading. *See* Pls.' Reply to DSAF ¶ 11, *infra*. Even Harris personnel have expressed concern over trying to justify the fee discrepancy between Harris's non-mutual fund clients and the Funds. *See* Pls.' Reply to DSAF ¶ 11, *infra*.

(d) Harris Unduly Dominated the Trustees

Harris unduly dominated the trustees, thereby preventing them from fulfilling their fiduciary duties.

(i) Breakpoints

When the trustees of the Funds considered implementing breakpoints for the Equity and Income Fund in 2002, the portfolio manager for the Fund, Clyde McGregor, "strongly opposed the addition of breakpoints" and indicated that he would close the Fund rather than decrease Harris's profitability. *See* Minutes of Meeting of Management Contracts Committee, Sept. 11, 2002 (HA0005067) [attached as Exhibit C-33], at p. 2 ("Mr. McGregor strongly opposed the addition of breakpoints . . . [and] indicated that in lieu of implementing breakpoints and decreasing the Adviser's profitability, [he] would rather

close the Fund to new investors."). The meeting where McGregor's threat to close the Fund was discussed was attended in person by one disinterested trustee (three others participated by phone) and five Harris executives, including John Raitt (CEO of Harris). Thus, Harris personnel outnumbered the disinterested trustees five to four, and the sole trustee who participated in person five to one. *See id.* at p. 1. Needless to say, no breakpoints were instituted during this contract cycle. *See* Pls.' Reply to DSAF at ¶¶ 3-5, *infra*.

Harris continued to resist the introduction of breakpoints. In 2003, John Raitt suggested that instituting breakpoints for the Funds would make them "less attractive" to manage and that Harris would "reserve [its] limited investment capacity for [its] higher fee business." Printed and Handwritten Notes of John Raitt (HA0008958-59) [attached as Exhibit C-34] (also containing handwritten note by someone else stating that Harris would "sell out to highest bidder"); *see also* Handwritten Notes of John Raitt (HA0001879-87) [attached as Exhibit C-35] at HA0001884 (referring to "Profit Maximization" and "shift[ing] efforts to highest net fee bus[iness]"); *id.* at HA0001885 (stating that Harris is a "Profit Maximizer" and that Harris "will close" and "will shift business to institutional"); Raitt Dep. at 236-41, 245 [Exhibit B-8] (explaining notes at HA0001884-85 in the context of a discussion with the trustees about breakpoints in 2003). Raitt openly admitted at his deposition that Harris "would be likely to pursue growth in other businesses and possibly add additional resources to other businesses

at the expense of the funds." Raitt Dep. at 41 [Exhibit B-8] (Raitt tried to correct this statement with the meaningless distinction that he meant "in lieu of the funds" rather than "at the expense of the funds").

Ultimately, Harris refused to implement any breakpoints that would result in an immediate reduction of fees (or concomitant passing on of economies of scale). Rather, Harris would only agree to breakpoints for future, unrealized asset growth because Harris did not want to reduce its profits, or as one trustee put it at his deposition, Harris's "bottom line." *See* Hayden Dep. at 145-58 [Exhibit B-3]; Wilner Dep. at 166-68 [Exhibit B-14]; *see also* Email Re: Meeting with John Raitt, Sept. 28, 2004 (IT-MF00150) [attached as Exhibit C-32] (expressing Harris's concern with proposed breakpoints that would "impact Harris's profit (discretionary income)"). One trustee expressed his belief that Harris would "not accept any reduction of current fees" and indicated that Raitt told him that Harris was "willing to look at lower breakpoints going forward, but nothing that reduces fees as they [currently stand]." *Id.* Ultimately, the trustees capitulated to Harris as none of the breakpoints added to the fee schedules for the Funds have resulted in current fee reductions. *See* Pls.' Reply to DSAF ¶ ¶ 3-5, *infra*.

(ii) Economies of Scale

Michael Friduss, one of the disinterested trustees attempted his own analysis of economies of scale. His analysis graphed Harris's revenues and costs and clearly demonstrated that Harris's costs declined as a percentage of

revenues as the assets of the Funds grew. *See* Oakmark Economies of Scale (HA0009236-45) [attached as Exhibit C-14]. However, Harris personnel, including CEO John Raitt, were very critical of the analysis. *See* Raitt Dep. at 255 [Exhibit B-8] ("The analysis . . . had several problems with it. There are some basic input errors. There was some errors in methodology and some weaknesses in presentation."); *see also* Rowsell Dep., June 15, 2005, at 233 [Exhibit B-11] ("I remember problems with these graphs having data out of order, for example; and I felt like they were not a fair depiction of the revenues and expense data they were trying to represent."). Harris made some attempt to re-create Friduss's charts, but offered no insight into economies of scale or further assistance in understanding the charts. *See* Raitt Dep. at 258-61 [Exhibit B-8]; Friduss Dep. at 119-20 [Exhibit B-2]. Ultimately, the trustees (including Friduss) essentially rejected the analysis and drew no conclusions from it. *See* Friduss Dep. at 112, 119, 124-131 [Exhibit B-2]; Hayden Dep. at 24, 26, 32 [Exhibit B-3]; Wilner Dep. at 171-73 [Exhibit B-14]. The trustees made no other attempt to determine whether the Funds were experiencing economies of scale and whether such economies of scale were being shared with the shareholders. *See* Rotter Dep. at 96-97, 102 [Exhibit B-10]; Ruder Dep. at 84 [Exhibit B-13]. Nor did the trustees seek assistance from anyone in making such a determination. *See* Friduss Dep. at 121-28 [Exhibit B-2]. In fact, although Friduss claimed to have conducted "much research" on economies of scale, he was completely ignorant of widely publi-

cized studies by the SEC and GAO. *See* Friduss Dep. at 115-18 [Exhibit B-2]. One disinterested trustee even admitted that he did not consider economies of scale realized by Harris. *See* Deposition of Allan Reich, Nov. 11, 2005 [attached as Exhibit B-9], at 135 ("I don't look at specifically revenues – economies of scale that may be realized by the advisor per se.").

(e) Schemes to Extract Additional Monies from the Funds

Unbeknownst to the trustees, Harris participated in various schemes to extract additional monies from the Funds.

(i) Duplicative Commissions

During the relevant damages period, the Funds paid millions of dollars in commissions to Harris Associates Securities L.P. ("HASLP"), an affiliated broker, for brokerage services. *See* SAI, Jan. 28, 2005 [attached as Exhibit D-5], at p. 37. HASLP had no employees, and these brokerage services, including trade aggregation, were actually performed by Harris personnel. *See* Deposition of Clyde McGregor, Aug. 31, 2005 [attached as Exhibit B-4], at 196-204; Raitt Dep. at 103-106 [Exhibit B-8]. However, Harris was already being compensated to provide services such as trade aggregation as part of the advisory agreements with the Funds. *See* Investment Advisory Agreements for the Oakmark Fund, Oakmark Equity and Income Fund, and Oakmark Global Fund, Oct. 30, 2000 (HA0015481, HA0015628, HA0015759) at ¶¶ 2(b), 4 [Exhibit C-18] (requiring Harris to "place all orders for the purchase and sale of portfolio securities" and to furnish all "personnel neces-

sary to render the[se] services"). Essentially, the Harris traders exercised their discretion to place orders with HASLP by "switching hats" and assuming their role as HASLP brokers. In effect, Harris personnel placed the orders with themselves and received brokerage commissions on top of the advisory fees they were already receiving. *See* McGregor Dep. at 196-204 [Exhibit B-4]; Raitt Dep. at 103-106 [Exhibit B-8]; *see also* Bullard Report ¶¶ 30-36 [Exhibit A-1]. Clyde McGregor, a senior portfolio manager at Harris, conceded that Harris's arrangement with HASLP was confusing and difficult to justify. *See* McGregor Dep. at 200 [Exhibit B-4] ("[I]t's something that confused me from time to time – the day I first became a portfolio manager in 1986, and I'm still confused with it now. . . ."); *id.* at 197 ("Well you had one pool of trades that was being done [through the] Merrill Lynches of the world, another pool of trades that was being done through Harris Associates Securities, and it was becoming ever more difficult to – explain that, frankly."). The trustees of the Funds were unaware that HASLP had no employees and that the work was actually performed by Harris personnel. *See, e.g.*, Wilner Dep. at 134-36 [Exhibit B-14].

(ii) Fees Paid to Intermediaries

Fees paid to intermediaries who distributed shares of the Funds were paid in part by the Funds. The Funds paid 43% of the fees subject to a cap based on fees paid to the affiliated transfer agent. To the extent that the portion of the intermediary fee paid by the Funds exceeded what the Funds would have paid to the

affiliated transfer agent, Harris reimbursed the Funds. *See* Memo Re: Evaluation of Agreement to Allocated Service Provider Fees, June 18, 2003 (HA0003323) [attached as Exhibit C-3]. However, unbeknownst to the trustees for the Funds, Harris endeavored to reduce the amount of the reimbursements by using undisclosed accounting methodologies so that the Funds would pay as much as possible. *See* Memo Re: Intermediary Profitability Review, March 12, 2004 (HA0009789-801) [attached as Exhibit C-15], at HA0009790 (item 3) ("Re Schwab and Fidelity, HALP had done all that it could to reduce reimbursements by taking Fidelity Global accounts omnibus and using average account size for accounts where participant numbers did not make sense."). The trustees of the Funds were unaware of these efforts, and at least one trustee conceded [after the fact] that Harris's activities were wrongful. *See* Wilner Dep. at 174-86 [Exhibit B-14]; *see also* Reich Dep. at 172 [Exhibit B-9]; Rotter Dep. at 20, 183-89 [Exhibit B-10].

3. The fee schedule for each of the Funds features "breakpoints," i.e., asset levels at which the fee declines.

REPLY: Denied in Part. At the beginning of the relevant damages period, August 17, 2003, the fee schedules for the Oakmark Equity and Income Fund and the Oakmark Global Fund did not contain breakpoints. Only the Oakmark Fund contained breakpoints in its fee schedule. However, these breakpoints were small and set at high levels of assets, such that the Oakmark Fund did not have sufficient assets to reach all of the breakpoints. Specifically, as of Sep-

tember 30, 2003, the Oakmark Fund had $4.791 billion in assets. *See* Statement of Additional Information, Oakmark Family of Funds ("SAI"), Jan. 31, 2004 (HA0006195) [attached as Exhibit D-4], at App. B (HA0006240)]. The fee schedule at the time contained a breakpoint of 10 basis points (0.10%) at $2 billion in assets, an additional breakpoint of 10 basis points (0.10%) at $3 billion in assets, and a final breakpoint of 5 basis points (0.05%) at $5 billion in assets. *See id.* at p. 19.

4. In recent years, the annual contract renewal process resulted in the initiation of additional breakpoints in the fee schedules of the Funds.

REPLY: Denied in Part. None of the breakpoints added to any of the Funds since the beginning of the relevant damages period resulted in a decline of fees when they were added. For instance, nominal breakpoints were added to the fee schedules for the Oakmark Equity and Income Fund and the Oakmark Global Fund that became effective November 1, 2003. *See* SAI, Jan. 31, 2004 (HA0006195), at p. 20 [Exhibit D-4]. The first breakpoint for the Oakmark Equity and Income Fund was 5 basis points (0.05%) at $5 billion, with additional breakpoints of 2.5 basis points (0.025%) at $7.5 billion and $10 billion. *See id.* The first breakpoint for the Oakmark Global Fund was 5 basis points (0.05%) at $2 billion, with an additional breakpoint of 5 basis points (0.05%) at $4 billion. *See id.* However, as of September 30, 2003, the Oakmark Equity and Income Fund had less than $5 billion in assets, and the Oakmark Global Fund had less than $2 billion in assets. *See id.* at App. B (HA0006252, HA0006257) [Exhibit D-4].

As of September 30, 2004, just after the end of the relevant damages period, the Oakmark Equity and Income Fund had assets of $8.057, just reaching its second breakpoint, and the Oakmark Global Fund had assets of only $1.361 billion, still not reaching any of its breakpoints. *See* Annual Report, Oakmark Family of Funds, Sept. 30, 2004 [attached as Exhibit D-6], at 24, 32. *See generally* Pls.' Reply to DSAF ¶ 2, *supra* (discussing breakpoints for the Funds and trustees' efforts and failures to implement breakpoints).

In addition to the nominal breakpoints discussed above, breakpoints were added to the fee schedules for the Oakmark Fund and the Oakmark Equity and Income Fund that became effective November 1, 2004 (after the relevant damages period). *See* SAI, Jan. 28, 2005, at p. 18 [Exhibit D-5]. Breakpoints of 5 basis points (0.05%) were added to the Oakmark Fund at $7.5 billion and $10 billion, and a breakpoint of 5 basis points (0.05%) was added to the Oakmark Equity and Income Fund at $12.5 billion. *See id.* However, as of September 30, 2005, neither the Oakmark Fund ($6.384 billion in assets) nor the Oakmark Equity and Income Fund ($9.805 billion in assets) had reached any of these breakpoints. *See* Annual Report, Oakmark Family of Funds, Sept. 30, 2005 [attached as Exhibit D-7], at 12, 23.

5. The following table summarizes the fee schedule for each of the Funds, as negotiated and approved by the trustees, including the additional breakpoints negotiated and approved by the trustees during 2003 and 2004:

The Oakmark Fund	Equity & Income Fund
First $2.0 billion under mgmt: 1.00%	First $5.0 billion under mgmt: 0.75%
Next $1.0 billion under mgmt: 0.90%	Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2003)*
Next $2.0 billion under mgmt: 0.80%	Next $2.5 billion under mgmt: 0.675% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.75%	Next $2.5 billion under mgmt: 0.65% *(New breakpoint as of 11/1/2003)*
Next $2.5 billion under mgmt: 0.70% *(New breakpoint as of 11/1/2004)*	
Net assets over $10 billion 0.65% *(New breakpoint as of 11/1/2004)*	Net assets in excess of $12.5 billion: 0.60% *(New breakpoint as of 11/1/2004)*

Global Fund
First $2.0 billion under mgmt: 1.00%
Next $2.0 billion under mgmt: 0.95% *(New breakpoint as of 11/1/2003)*
Net assets in excess of $4 billion: 0.90% *(New breakpoint as of 11/1/2003)*

REPLY: While the chart reflects the current fee schedules for the Funds, the majority of the nominal breakpoints reflected in the schedules are not applicable given the assets of Funds during and after the relevant damages period. *See* Pls.' Reply to DSAF ¶¶ 3-4, *supra*. In addition, the fee schedules were not negotiated at arms-length or legally approved. *See* Pls.'

Reply to DSAF ¶ 2, *supra*. Specifically with regard to breakpoints, Harris repeatedly resisted the institution of breakpoints and refused to accept breakpoints that would result in actual fee reductions when approved. *See id.* Also, the breakpoints were set according to irrelevant considerations rather than being based on Harris's profits or its costs of providing services. *See id.*

6. The annual process of negotiating and approving Harris's advisory contract and fees pursuant to Section 15(c) of the ICA spans several months and involves multiple meetings between Harris and certain of the trustees.

REPLY: Denied in part. While the trustees and Harris conducted multiple meetings related to the renewal of the advisory contracts between Harris and the Funds, the fees were not negotiated at arms length or legally approved in compliance with the ICA. *See* Pls.' Reply to DSAF ¶ 2, *supra*.

7. Much of the trustees' information-gathering and analysis undertaken pursuant to Section 15(c) of the ICA is completed by a Management Contracts Committee of the board, which then makes a recommendation to the full board for consideration. The Management Contracts Committee met five times over the course of five months in 2002, four times over the course of five months in 2003, and four times over the course of the six months prior to the filing of the complaint in this action in August 2004.

REPLY: While Plaintiffs admit that the meetings referenced by Defendant took place, Plaintiffs deny that these meeting demonstrate an arms-length negotiation or that the process

resulted in legally approved contracts that comply with § 15(c) of the ICA. *See* Pls.' Reply to DSAF ¶ 2, *supra*.

8. The trustees are advised throughout this process by independent, outside counsel from the firm of Bell Boyd & Lloyd.

REPLY: Plaintiffs admit that the minutes of the meetings referenced by Defendant indicate that representatives of Bell Boyd & Lloyd attended the meetings; however, the minutes do not establish that Bell Boyd & Lloyd was independent. Even if Bell Boyd & Lloyd was independent, the fees paid by the Funds were not the result of an arms-length negotiation or legally approved. *See* Pls.' Reply to DSAF ¶ 2, *supra*.

9. Each year, Harris provides to the trustees at their request information on a variety of topics: the services provided by Harris to the Funds in exchange for the fees; the Harris personnel providing those services; the investment performance of the Funds; the profitability of the advisory contracts to Harris, including detailed information about Harris expenses; certain transactions between the Funds and entities affiliated with Harris (e.g., Harris's affiliated broker); benefits accruing to Harris in addition to fees (e.g., use of "soft dollars" to offset the cost of research services); and compliance information, including information about the best execution of portfolio transactions for each Fund, allocation of purchase and sale transactions among broker-dealers and compliance with the Funds' investment restrictions.

REPLY: Denied in part. The fees during the relevant damages period were paid by the Funds pursuant to contracts negotiated prior

to the May 2004 Request cited by Defendant in support of this statement of additional fact. Prior to May 2004, the trustees issued no formal request for information, and much of the information in the Request was not provided. Accordingly, the Request referenced by Defendant is irrelevant to Plaintiffs' claims.

Furthermore, both before and after this Request, Harris failed to provide all necessary information for the trustees to make an informed decision regarding the fees paid by the Funds and, in some cases, provided the trustees with false and misleading information, including the information referenced in this statement of additional fact. *See* Pls.' Reply to DSAF ¶ 2, *supra*.

10. The trustees also commission a third-party industry consultant known as Lipper to provide certain requested data. These materials include comparisons of the Oakmark Funds' investment performance, fees, and profitability to those of a peer group of the Funds' competitors. The investment performance figures in the Lipper materials are reported net of the advisers' fees. The Lipper materials also present data on fees in isolation from the net performance figures. The 2004 Lipper report shows total expenses for each Fund as follows: Global Fund was 0.168% below the median for its peer group, the Equity and Income Fund was 0.025% above the median for its peer group and the Oakmark Fund was 0.174% above the median for its peer group.

REPLY: Admitted, but irrelevant. The 2004 Lipper Report was provided to the trustees during the contract renewal period for fees paid in 2005 (after the relevant damages period).

The Lipper Reports relevant to the renewal periods for the fees paid in 2003 and 2004 show that the Oakmark Fund and the Oakmark Equity and Income Funds compared unfavorably with their peers. *See* Lipper Report, Harris Associates Investment Trust, June 25, 2002 (HA0082587) [attached as Exhibit C-39], at HA0082599-604 (Oakmark Fund), HA0082682-87 (Oakmark Equity and Income Fund); Lipper Report, Harris Associates Investment Trust, June 6, 2003 (HA0001298) [attached as Exhibit C-40], at HA0001316-21 (Oakmark Fund), HA0001404-09 (Oakmark Equity and Income Fund). Moreover, Harris provides the identical services it provides to the Funds to institutional accounts for much lower fees. *See* Pls.' Reply to DSAF ¶ 11, *infra*. Harris did not provide this information to the trustees during the relevant damages period. When Harris finally did provide such information, the information was false and misleading. *See id.*

11. At the request of the trustees, the 15(c) materials also describe which of the services provided by Harris to the Funds are not provided to Harris's non-mutual fund clients.

REPLY: While Plaintiffs admit that (after the relevant damages period) the trustees receive materials purporting to describe services provided to the Funds that are not provided to Harris's other clients, these materials are false and misleading.

In addition to providing advisory services to the Oakmark Funds, Harris provides advisory services to a variety of non-mutual fund clients, including pension funds, retirement

accounts and subadvisory accounts ("institutional accounts"). The advisory services provided to the institutional accounts are virtually identical to the advisory services provided to the Oakmark Funds. In fact, Harris's research department is managed as a single entity, and the research conducted is used equally by all clients. Indeed, portfolio managers for both the Funds and the institutional accounts are not only given the same research, but attend the same weekly stock selection meetings. There is virtually no difference in the day-to-day management activities between the mutual funds and the institutional accounts, and the same people who manage the institutional accounts contribute to the management of the Oakmark Funds. ***See*** **Deposition of Henry Berghoef, Aug. 30, 2005 [attached as Exhibit B-1], at 35-37, 81-83, 152-156; McGregor Dep. at 35-37 [Exhibit B-4]; Nygren Dep. at 43 [Exhibit B-7]; Harris Associates Domestic Architecture (HA_S000127570) [attached as Exhibit C-24] at HA_S000127575-77 (describing investment process);** ***see also*** **Pomerantz Report at 15 [Exhibit A-6]; Pomerantz Rebuttal at 2-4 [Exhibit A-6]; Declaration of Edward S. O'Neal [attached as Exhibit A-5] at Report at 19-20; Lamb Report at 17 [Exhibit A-4]; Lamb Rebuttal at 4-6 [Exhibit A-4]. In addition, the portfolio holdings of the institutional accounts are consistent with mutual funds that share the same strategy. For example, during a given time period, institutional accounts in Harris's large cap strategy will contain most of, if not all, the same stocks as the Oakmark Fund.** ***See*** **Harris Associates Domestic Architecture (HA_S000127570)**

at HA_S000127577 [Exhibit C-24] ("Our large Cap institutional portfolios consist of approximately 40 stocks (40-50 stocks). The Oakmark Fund, a more diversified portfolio, contains most – if not all – of the same stocks during a given time period."). In fact, Harris's standard response to requests for proposals suggests that clients seeking a large cap strategy can invest in either the Oakmark Fund or separate institutional accounts, identifying minimum account size as the only difference. *See id.* at HA_S000127705 [Exhibit C-24].

Any differences between the advisory services provided to the Oakmark Funds and those provided to the institutional accounts are de minimis in terms of their cost to Harris. In fact, even considered in isolation, a conservative estimate of the fully allocated costs (including overhead) of the departmental personnel that provide services to the Funds, but not the institutional accounts, amounts to 1.56 basis points of the Fund assets (0.0156%) (this includes the total costs of the Fund Operations and Fund Accounting Departments). Nonetheless, Harris charges the Funds fees that are 40 to 65 basis points higher than those charged to the institutional accounts. *See* Lamb Rebuttal at 4-6 [Exhibit A-4]; Pomerantz Rebuttal at 2-4 [Exhibit A-6]; HA0009830 (source data for costs) [Exhibit C-26]; HA_N000000331 (source data for salaries) [attached as Exhibit C-28]; HA_N000000003 (source data for assets) [Exhibit C-27]. Moreover, an examination of all of Harris's costs shows that Harris's institutional business is more costly to Harris than the Funds in relationship to assets under management. In fact,

out of Harris's 179 fulltime-equivalent employees (FTEs), only 50 FTEs (28%) are dedicated to the Funds, while 129 FTEs (72%) are dedicated to Harris's other clients, even though the Funds comprise almost half (48%) of Harris's $36.5 billion in assets under management. The fully allocated costs (including overhead) of all FTEs who provide services to the Funds is between 2.8 and 6.5 basis points less than the fully allocated costs (including overhead) of all FTEs who provide services to Harris's other clients. *See* Lamb Rebuttal at 4-6 [Exhibit A-4]; Pomerantz Rebuttal at 2-4 [Exhibit A-6]; HA0009850 (source data for time estimates) [attached as Exhibit C-25]; HA0009830 (source data for costs) [Exhibit C-26], HA_N000000331 (source data for salaries) [Exhibit C-28], HA_N000000003 (source data for assets) [Exhibit C-27].

Despite the fact that the advisory services Harris provides to the institutional accounts are virtually identical to those provided to the Oakmark Funds, and despite the fact that the institutional business is more costly to Harris than the Funds, the Funds pay advisory fees that are nearly twice as much or more than the fees paid by the institutional accounts. This is so even though the Funds are all much larger than the institutional and subadvisory accounts. *See* O'Neal Report at 17-20 [Exhibit A-5]; Pomerantz Report at 16-20 [Exhibit A-6]; Lamb Report at 17-21 [Exhibit A-4]; *see also* Institutional Account Data (HA0135007-12, HA0135013X-27X, HA0135028A) [Exhibit C-20]; Harris Associates Investment Trust, Responses to Information Request, May 2004 (HA0000211), at Item D.2 (HA0000437-55) [Exhibit C-1]. If the Oak-

mark Fund were subject to the same fee schedule as comparable institutional accounts, the effective fee for the Oakmark Fund would be 35.2 basis points, or 52.8 basis points less than what the Oakmark Fund pays. If the Oakmark Equity & Income Fund were subject to the same fee schedule as comparable institutional accounts, the effective fee for the Oakmark Equity & Income Fund would be 25.4 basis points, or 47.6 basis points less than what the Oakmark Equity & Income Fund pays. If the Oakmark Global Fund were subject to the same fee schedule as comparable institutional accounts, the effective fee for the Oakmark Global Fund would be 51.3 basis points, or 48.7 basis points lower than what the Oakmark Global Fund pays. If Harris had charged the Funds fees that were comparable to fees charged to similar institutional accounts, the Funds would have saved between $37 million and $58 million during the relevant damages period. ***See*** **O'Neal Report at 17-20 [Exhibit A-5]; Pomerantz Report at 16-20 [Exhibit A-6]; Lamb Report at 17-21 [Exhibit A-4];** ***see also*** **Institutional Account Data (HA0135007-12, HA0135013X-27X, HA0135028A) [attached as Exhibit C-20]; Harris Associates Investment Trust, Responses to Information Request, May 2004 (HA 0000211), at Item D.2 (HA0000438, HA0000440, HA 0000442) [Exhibit C-1].**

For purposes of considering and approving the fees paid by the Funds during the relevant damages period, the trustees of the Funds never received information about the services Harris provided to its other clients or the fees Harris charged to its other clients. The trus-

tees first requested this information on March 31, 2004 (for reviewing fees to be paid in 2005). *See* Letter Re: Harris Associates Investment Trust, March 31, 2004 (HA0009268) [attached as Exhibit C-16], at HA0009270 (trustees requesting a "[c]omparison of [Harris's] management fees for each Fund with fees charged by [Harris] to any other large institutional or other clients with comparable investment objectives"). When Harris finally provided this information, it falsely and misleadingly indicated that Harris provided greater and more costly services to the Funds. *See* Harris Associates Investment Trust, Responses to Information Request, May 2004 (HA0000211) at Item C.1 (HA0000327-31) and Item D.2 (HA0000437-55) [Exhibit C-1]. Harris failed to point out to the trustees that the Funds pay additional fees to Harris or its affiliates for providing many of the services listed by Harris. *See* Transfer Agency and Service Agreements (HA0013815-50) [attached as Exhibit C-36]; Custodian Agreement (HA0013462-89) [attached as Exhibit C-37]; Administration Agreement (HA0013448-60) [attached as Exhibit C-38]. Harris also failed to inform the trustees that the advisory services Harris provides to the institutional accounts are virtually identical to those provided to the Funds and that the institutional business is more costly to Harris than the Funds.

Even Harris investment professionals and marketing personnel expressed concern over explaining the fee gap between the Funds and similarly managed institutional accounts. In an email exchange between Bill Nygren, portfolio manager of the Oakmark Fund, and Michael

Neary, head of marketing at Harris, Neary stated: "I worry less about the fee gap in sub-advised than I do institutional." Nygren replied: "I'm just worried about trustee relations and maintaining our existing [mutual] fund fees – it would be nice to be able to answer [the question of whether the mutual fund fees are similar to what other large accounts pay] affirmatively .... And I have suggested to Clyde [McGregor, portfolio manger of the Oakmark Equity and Income Fund,] that as a 'premium manager', he should not be offering to manage new accounts at our normal institutional rates." *See* Email Re: Proposed SEC Rules on Manger Compensation, March 11, 2004 (HA_E0237411) [attached as Exhibit C-22]. In a follow-up email the next day, Neary suggested that if the Funds are compared to accounts with a "similar strategy," then Harris's defense regarding the fee discrepancy "is weak but not zero." He also suggested that another Fund portfolio manager was "in a more difficult situation" because "[h]is institutional accounts are nearly identical and his fee gap approaches 40 [basis points]." *See* Email Re: a few items, March 12, 2004 (HA_E0023970) [attached as Exhibit C-23].

12. For the three year period ended March 31, 2004, the Oakmark Equity and Income Fund generated an average annual return of 12.49%, net of fees, the third best performance during that three year period of the 445 funds in its performance universe, as defined by Lipper, and above its benchmark, the Lipper Balanced Fund Index, which had an average annual return of 3.76%. For the five year period ending March 31, 2004, the Oakmark Equity and Income

Fund's average annual net return of 13.91% was the single best performance result of any fund its performance universe, and above its benchmark figure of 3.11%.

REPLY: *See* Pls.' Reply to DSAF ¶ 14, *infra*.

13. For the three year period ended March 31, 2004, the Oakmark Fund generated an average annual return of 6.22% net of fees, giving it a rank of 12 out of 307 funds in its Lipper performance universe, and placing it above its benchmark, the Lipper Large-Cap Value Index, which had an average annual return of 1.43%. For the five year period ended March 31, 2004, the fund's average annual net return was 5.29%, giving it a rank of 18 out of 224 funds in its performance universe, and above its benchmark figure of 1.22%.

REPLY: *See* Pls.' Reply to DSAF ¶ 14, *infra*.

14. For the three year period ended March 31, 2004, the Oakmark Global Fund generated an average annual return of 22.36%, net of fees, the single best performance result of any of the 254 funds in its performance universe, as defined by Lipper. This return was above its benchmark, the Lipper Global Fund Index, which had an average annual return of 2.31%. For the four year period ending March 31, 2004, the Oakmark Global Fund's average annual net return of 20.24% was the single best performance result of any fund its performance universe, and above its benchmark, which had an average annual loss of 4.8%.

REPLY: Admitted. However, viewing a more relevant period of performance for the Funds reveals a different picture. The relevant damages period is August 17, 2003, to August 16, 2004, and Plaintiffs continue to hold shares in

the Funds to the present day. Since roughly the beginning of the damages period to roughly the present (the three year period ended August 31, 2006), the Lipper Rankings for the Funds are as follows: Oakmark Fund – 469 out of 720; Oakmark Equity and Income Fund – 92 out of 447; Oakmark Global Fund – 6 out of 56. The Oakmark Fund in particular has performed poorly and has a Morningstar Rating of only one star. *See* The Oakmark Funds, Fund Ratings and Rankings, Aug. 31, 2006 (http://www.oakmarkfunds.com/opennews.asp?newsid=192&news_from=h#Lipper) [attached as Exhibit E].

15. On January 17, 2001, Mr. Morgenstern explained to the other trustees that he would be stepping down as an executive of Harris, but wished to remain as chair of the board of trustees. The trustees were advised by their independent legal counsel that Mr. Morgenstern "would no longer fall within the statutory definition of 'interested' trustee unless the Securities and Exchange Commission, after an opportunity for a hearing, were to issue an order determining that Mr. Morgenstern prospectively would be an interested trustee by reason of having had a material business relationship with [Harris] . . . ." The trustees' counsel further advised that "[e]ven if Mr. Morgenstern were subsequently determined to be an interested trustee, that determination would not impair the validity of action taken by Mr. Morgenstern during the period that he was a non-interested trustee. Moreover, even at the present time, the board has a super-majority (seven out of nine) non-interested trustees." The board unanimously approved Mr. Morgenstern's continued service as board chair.

REPLY: While Plaintiffs admit that the Minutes referenced in this statement of additional fact reflect the advice of counsel stated above, Plaintiffs deny that the advice was correct. Morgenstern was in fact an interested person of Harris. *See* Pls.' Reply to DSAF ¶ 2, *supra*; PSOF ¶¶ 11, 13, 21-25, 36.

16. During the Governance committee meeting held on January 17, 2001, Mr. Morgenstern specifically disclosed that he would continue to receive deferred compensation from Harris in a fixed amount following his retirement: "Mr. Morgenstern informed the committee that he would not be entitled to any compensation from [Harris] for services rendered after January 31, 2002, although he expected to receive a fixed amount payout from [Harris] for his partnership interest to be paid in installments over the next several years."

REPLY: Plaintiffs admit that the Minutes referenced in this statement of additional fact reflect that Morgenstern made the disclosure set forth above, and Plaintiffs further admit that the disclosure was accurate in that Morgenstern's C-Plan compensation was related to his "partnership interest" in Harris. However, the disclosure was false and misleading in that it referred to Morgenstern's C-Plan compensation as fixed. Rather, the compensation was subject to reduction based on certain limits associated with Harris's revenues. *See* PSOF ¶¶ 21-22. For example, in 2001 (Morgenstern's first year of eligibility for C Plan Compensation) Morgenstern received less than his targeted amount because Harris's revenues in 2001 were not sufficient to entitle him to the entire $632,125. *See* PSOF ¶ 23. Furthermore, Morgenstern's

C-Plan compensation was never disclosed in the registration statements for the Funds. *See* PSOF ¶ 51.

17. The other trustees periodically reviewed Mr. Morgenstern's performance as board chair. The October 21, 2003 minutes of the board's Governance Committee reflect that "each trustee offered accolades regarding Mr. Morgenstern's performance. . . . [T]he trustees also acknowledged that Mr. Morgenstern's previous experience with [Harris] provided additional insight into many aspects of [Harris's] operations. At the same time, the trustees agreed that Mr. Morgenstern has severed all his formal and financial ties to [Harris] and was truly independent."

REPLY: Plaintiffs deny that Defendant's citation to one set of board minutes established that the trustees "periodically" reviewed Morgenstern's performance. In addition, Plaintiffs deny that the trustees honestly agreed that Morgenstern had severed all his financial ties to Harris. In fact, several of the trustees were aware that Morgenstern received compensation from Harris. *See* Wilner Dep. 37, 40-41 [Exhibit B-14] (Wilner knew that Morgenstern received compensation from Harris but did not know how it was calculated or that it was tied to Harris's revenues); Ruder Dep. 61, 64-66 [Exhibit B-13] (Ruder knew of compensation but was not aware that it could be affected by Harris's revenues); Reich Dep. 38 [Exhibit B-9] (Reich knew of compensation); Friduss Dep. 46-51 [Exhibit B-2] (Friduss knew of compensation and that it was related to Harris's profits and connected to the fees paid by the Funds, but Friduss did not believe that this created even an appearance of a conflict). Morgenstern was

an interested person of Harris. ***See*** **Pls. Reply to DSAF ¶ 2,** ***supra.***

Respectfully submitted,

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Attorneys for the Plaintiffs

October 24, 2006

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

[filed Oct. 24, 2006]

DEFENDANT HARRIS ASSOCIATES L.P.'S REPLY TO PLAINTIFFS' STATEMENT OF ADDITIONAL FACTS

Harris sets forth below its response to "Plaintiffs' Statement of Additional Facts," submitted in conjunction with plaintiffs' opposition to Harris's summary judgment motion. While denominated a statement of "facts," plaintiffs' submission is instead largely argument that restates and summarizes at length the opinions of plaintiffs' six expert witnesses. As set forth in the following paragraphs, Harris disputes many of plaintiffs' characterizations of the record, and also respectfully submits that much of the material included in "Plaintiffs' Statement of Additional Facts" is in fact not properly included in such a paper under the Local Rules. Moreover, plaintiffs improperly cite to and rely upon "rebuttal

reports" from their expert witnesses, despite the fact that the Court has not granted leave for plaintiffs to submit such reports and Harris has not had an opportunity to depose those experts on the additional proffered reports.

In any event, Harris respectfully submits that materials included in "Plaintiffs Statement of Additional Facts" – whether argument, opinion, or fact – do not give rise to a disputed issue of material fact for purposes of summary judgment. As set forth more fully in Harris's briefs, under the established standard governing plaintiffs' excessive fee claims under Section 36(b), nothing in the "Plaintiffs' Statement of Additional Facts" permit an inference that the fees Harris charged the Funds during the relevant year were "so disproportionately large" compared to the value of rendered services that they "could not" have been bargained at arm's length. *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (2d Cir. 1982). Any disputes over alleged facts which, even if true, would not permit such an inference cannot be material disputes for purposes of summary judgment.

1. From January 1, 2001 to July 16, 2003, the Board of Trustees for the Oakmark Fund, Equity and Income Fund, and Global Fund ("Funds") was comprised of eight "disinterested" trustees and one "interested" trustee. The disinterested trustees were: Victor Morgenstern (Chairman), Gary N. Wilner, Burton W. Ruder, Marvin R. Rotter, Michael J. Friduss, Allan J. Reich, Thomas H. Hayden, and Christine M. Maki. On July 16, 2003, John Raitt, President and CEO of Harris, was added as an interested trustee. This composition remained in place until Morgenstern resigned as a disinterested trustee effective January 1, 2005.

Response: Undisputed.

2. The trustees of the Funds were unable to evaluate the profitability of the Funds to Harris because the information that Harris provided regarding the Funds' profitability was materially misleading and substantially misstated Harris's actual profitability. This profitability information (1) allocated expenses in a manner that over-allocated expenses to large funds, under-allocated expenses to small funds, and masked economies of scale; (2) improperly treated profit sharing payments to the partners at Harris as an expense; (3) impermissibly included marketing expenses; and (4) lacked any outside verification of the methodology or data used and lacked adequate documentation.

Response: This paragraph comprises expert opinion testimony that is not properly included in the Statement. Harris disputes this characterization of the record, but submits that any such dispute is not material for purposes of summary judgment for the reasons set forth in its briefs. *See* Expert Report of Thomas M. Blake ("Blake Rep."), attached as Ex. 3 to Decl. of Brian R. Blais ("Blais Reply Decl."), at 6 ("During the Relevant Period, HALP's managerial accounting system was monitored, maintained and assessed on a consistent basis. The managerial accounting system perform financial analyses in a reasonable manner, fulfilled its intended purpose of producing decision making information, and was supported by reasonable assumption and documentation"); *id.* at 11 ("HALP utilized a reasonable methodology and had a supportable basis for determining the costs charged to the Oakmark Funds.").

3. Harris allocates costs among its lines of business primarily based on headcount, assets and fund revenues. Harris then allocates the costs in each line

of business (excluding marketing costs) among funds based on their percent of revenues. Because all pre-marketing expenses are allocated by the percent of revenue each fund generates within its line of business, the pre-marketing profit ratios are identical for all funds within a business line (i.e. domestic and international – with global being a blend of both). Profitability results from such an allocation methodology do not accurately portray the consumption of shared expenses or reflect the true cost of activities required to operate a mutual fund. For instance, large, established funds are portrayed as requiring proportionately more investment management costs than smaller, less mature funds. This resulted in fund-by-fund economies of scale, as evidenced through increasing profit margins as assets grow, being hidden from the trustees for the Funds, rendering the profitability analyses misleading to the trustees of the Funds.

Response: It is undisputed that Harris allocates it costs among its line of business primarily based on headcount, assets and fund revenue and that it then allocates the costs in each line of business (excluding marketing costs) among funds based on their percent of revenue. Harris disputes that this allocation methodology does not accurately portray the consumption of shared expenses, reflect the true cost of activities required to operate a mutual fund, or hide fund-by-fund economies of scales, *see* sources cited in ¶ 2, *supra*, and additionally submits that any such dispute is not material for purposes of summary judgment for the reasons set forth in its briefs. The fourth, fifth and sixth sentences in this paragraph comprise expert opinion testimony that is not properly included in the Statement. Harris also submits that Plaintiffs cannot establish issues of fact in reli-

ance upon "rebuttal" expert reports as to which this Court has not granted leave to submit.

4. Harris's profitability analyses treated the discretionary compensation payments to the partners of Harris as an expense. This component of Harris's "expenses" is substantial and amounted to 37% of Harris's total mutual fund revenues in both 2002 and 2003. However, the vast majority of these compensation payments represent additional profits of Harris and are made as profit-sharing payments.

Response: It is undisputed that the profitability analyses treated the discretionary compensation payments to the employees of Harris characterized as "partners" as an expense and that such payments represented 37% of Harris's total mutual fund revenues in both 2002 and 2003. The third sentence of this paragraph comprises expert opinion testimony that is not properly included in the Statement. Harris disputes Plaintiffs' characterization of these payments as "profits" rather than compensation, but submits that any such dispute is not material for purposes of summary judgment for the reasons set forth in its briefs. *See* Blake Rep. at 12 n.51 ("Compensation of $112.0 million is calculated based on adding $16.8 million for salaries, $6.5 million for bonuses and $88.7 million for deferred and discretionary compensation."). Harris also submits that Plaintiffs cannot establish issues of fact in reliance upon "rebuttal" expert reports as to which this Court has not granted leave to submit.

5. The total compensation of the Harris partners (the vast majority of which – 94% – is made up of discretionary compensation) greatly exceeds the median compensation (including salary, bonuses, and non-cash compensation) in the industry for individuals with the same job responsibilities in similar asset

management firms. Total compensation for Harris partners in 2003 was $75 million, or over six times higher than the median figures. The annual amounts of the discretionary compensation payments alone increased from $37.6 million in 2000 to $72.5 million in 2003, with individual payments to one partner exceeding $14 million in 2003 and $20 million in 2004 (over 17 times and 25 times the industry average of $793 thousand, respectively).

Response: With the exception of the final parenthetical, these facts are undisputed. Harris denies that these facts have any legal relevance without examining the corresponding value received by the shareholders of the Funds during the corresponding time period. Net of fees, the Funds were respectively ranked first, third, and twelfth in total return for the three year period ended March 31, 2004 against their peer groups of hundreds of other mutual funds. *See* Harris's Local Rule 56.1 Statement of Undisputed Facts ("L.R. 56.1 Stmt.") ¶¶ 25-27 and sources cited therein. Harris disputes that the relevant "industry average" compensation for comparable investment professionals is $793,000, and plaintiffs have made no showing that this is the case. Harris also submits that Plaintiffs cannot establish issues of fact in reliance upon "rebuttal" expert reports as to which this Court has not granted leave to submit.

6. Including the discretionary compensation payments made to the partners of Harris as an expense when calculating the profitability of the Funds to Harris greatly misrepresented Harris's profitability to the trustees of the Funds. If the discretionary compensation payments were treated as profits for purposes of Harris's profitability analyses, Harris's pre-marketing profit margin in 2003 would have been 91% rather than 54%, as reported to the

board. Even if you factor in a reasonable amount of compensation for the partners based on median industry compensation, and treat the remainder as profits, Harris's 2003 pre-marketing profit margins for the Oakmark Fund and the Oakmark Equity and Income Fund would increase from 54.5% to 86.4%, and its pre-marketing profit margins for the Oakmark Global Fund would increase from 52.5% to 78.9%. This does not even take into consideration Harris's flawed allocation methodology, which over-allocates costs to the larger funds. If Harris used an appropriate allocation methodology, the profit margins for the Oakmark Fund and the Oakmark Equity and Income Fund would have been even higher.

Response: This paragraph comprises expert opinion testimony that is not properly included in the Statement. Harris disputes that it is proper to include discretionary compensation payments as "profits" for the reasons set forth in its response to paragraph 5 above. Harris further disputes that there is any probative value to a calculation that imputes median industry compensation to Harris investing personnel, as this calculation ignores the benefits provided by Harris personnel to the Funds, which significantly outperformed industry medians during the three and five year period prior to the initiation of the complaint in this matter. *See* sources cited in ¶ 5, *supra*. Harris disputes that its cost allocation methodology was flawed. *See* sources cited in ¶ 2, *supra*. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

7. Harris's misrepresentation of the discretionary compensation as an expense influenced the trustees to believe Harris's profitability was lower than it really was. One trustee even stated that whether a

given individual received money because it was a share of profits or discretionary compensation or base salary or draw wasn't necessarily important to us." Moreover, while Harris attempted to justify the amount of compensation paid to the partners on the ground that the payments were necessary to be competitive in the industry so that Harris could retain investment professionals, the trustees had no basis to evaluate this justification because Harris never provided the trustees with the amounts of individual portfolio manager compensation. Accordingly, the trustees erroneously and baselessly believed that the compensation paid to the partners at Harris was "in line with" industry norms. Even when the trustees asked for specific compensation information, Harris refused to provide it because of the supposed "complexity" of the issue and the compensation process.

Response: This paragraph comprises expert opinion testimony that is not properly included in the Statement. Harris disputes that its characterization of discretionary compensation as a compensation expense was a misrepresentation for the reasons set forth in its response to ¶ 4, *supra*. Harris admits that it did not provide the trustees with the amounts reflecting individual portfolio manager compensation. Harris disputes that the deposition citations provided by Plaintiffs, which show only that the trustees did not know or were not provided information relating to the compensation of individual portfolio managers, establishes that these trustees "erroneously and baselessly believed that the compensation paid to the partners at Harris was 'in line with' industry norms." Harris admits that the minutes of the February 17, 2004 Management Contracts Committee meeting reflect that the complexity of the compensation process was one reason cited by Harris for not

disclosing individual portfolio manager compensation, but notes that these minutes further reflect that such information was not provided to the trustees of the Funds because "[i]ndividual compensation reflects payments for a mix of duties, including Fund and non-Fund duties . . . ." *See* Pls.' Ex C-11 at 2. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

8. Harris included marketing expenditures in the profitability analyses given to the trustees of the Funds. Prior to 2002, the profitability analyses showed fund by-fund profitability margins only on a post-marketing basis. Even after a line for the pre-marketing profit margin was added, however, the profitability analyses created the impression that the relevant profitability percentage for purposes of evaluating Harris's fund-by-fund profitability was the line titled "Profit Margin" (at the bottom of each page) as opposed to the pre-marketing profitability margin, which followed the line of expenses labeled "Subtotal" (implying that it was preliminary or incomplete).

Response: Harris admits that marketing expenditures were included in the profitability analyses given to the trustees of the Funds, but disputes that Plaintiffs' characterization of the "impression" these analyses purportedly create establishes an undisputed fact.

9. At least two trustees admitted that they considered marketing costs as an expense for purposes of evaluating Harris's profitability. Harris executives, and even the trustees' own counsel, repeatedly reinforced the independent directors' consideration of marketing expenses (specifically intermediary payments) in face-to-face meetings with the trustees.

Response: Harris disputes that the deposition transcripts cited by Plaintiffs constitute an "admission" that certain trustees considered marketing costs as an expense for purposes of evaluating Harris's profitability. *See* Dep. Tr. of Thomas Hayden, Pls.' Ex B-3, at 202 ("A. Yes. Technically, the way we have to look – the way we need to look at profitability excludes marketing . . . ."); *id.* at 203 ("Q: Does that mean you factor [marketing expenses] in or not? A: It means yes and no, depending on the analysis."); *id.* at 204 ("Q: It's not supposed to include marketing? A. Right"). Harris disputes that citation to a single set of meeting minutes establishes that Harris executives "repeatedly" reinforced the consideration of marketing expenses or that the mere fact that Harris executives or the Funds' counsel discussed the Funds' marketing expenses or their post-marketing profitability establishes "reinforcement" of the independent directors' consideration of marketing expenses. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

10. The methodology behind the profitability analyses Harris provided to the trustees lacked sufficient documentation and was not independently verified. Nor were the terms' sheets and workpapers associated with the profitability analyses shared with the trustees. Furthermore, the trustees decided not to obtain an objective evaluation of the profitability analyses.

Response: The first and third sentences of this paragraph comprise expert opinion testimony that is not properly included in the Statement. Harris disputes Plaintiffs' characterization of the facts. The Funds' independent counsel stated that "based on his experience, the information provided by the adviser

was at least as informative as the profitability analyses that other investment advisers provided to their fund clients." *See* Pls.' Ex. C-6 at HA 0005317. Additionally, the trustees decided not to obtain a third party evaluation of the profitability analyses after they "had examined whether the information could be reviewed by the Funds' independent auditors and subsequently determined that it would not be meaningful or cost effective to do so." *See id.* Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

11. Harris's financial data for the years 1999 to 2003 establish that Harris experienced significant economies of scale in its management of the Funds, that is, the costs to Harris in managing the Funds declined, on a percentage basis, as the assets of the Funds increased. Specifically, the personnel, occupancy and operating costs of Harris's Domestic Mutual Funds business unit and International Group (the majority of the revenues of these business units come from the Funds) all declined substantially with the asset growth of these business units from $5.7 billion to $26.7 billion (the average assets in these business units fell from $8.9 billion in 1999 to $5.7 billion in 2000 and then rose to $26.7 billion by the end of 2003). Furthermore, in 2000, when assets stood at $5.7 billion, personnel, occupancy and operating costs comprised 41% of total costs. In 2003, when assets grew to $26.7 billion, these costs comprised only 15% of total expenses.

Response: This paragraph comprises expert opinion testimony that is not properly included in the Statement. Harris disputes the calculations set forth above because they do not consider discretionary compensation, which is an expense of the Funds during the relevant time period for the reasons set forth

in ¶ 4, *supra*. Additionally, Harris's expert's analysis does not allow him to conclude that economies of scale are present at Harris. *See* Expert Report of Ajay Khorana ("Khorana Rep."), attached as Ex. 4 to Blais Reply Decl., at 10. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs. Harris also submits that Plaintiffs cannot establish issues of fact in reliance upon "rebuttal" expert reports as to which this Court has not granted leave to submit.

12. A regression analysis of Harris's costs also shows that marginal costs declined as assets grew, which also demonstrates that Harris experienced economies of scale. The cost to manage the first $500 million of assets is $950 thousand, while the cost to manage the second $500 million of assets is only $860 thousand. The cost to manage the tenth increment of $500 million in assets is $750 thousand. However, little to none of these economies of scale were shared with the shareholders of the funds. Rather, Harris retained these economies of scale for itself as additional profits. Indeed, Harris's profits increased in direct correlation with asset growth. For example, as the cost of managing incremental units of assets declined from $950 thousand for the first $500 million in assets to $810 thousand for the fourth $500 million in assets (a decline of 15%), marginal profit increased from $4.05 million, or 81% of revenue, to $4.19 million, or 84% of revenue.

Response: This paragraph comprises expert opinion testimony that is not properly included in the Statement. Harris disputes that the analysis presented above shows that Harris is achieving economies of scale. Harris's expert points out flaws in the methodologies used by both Pomerantz and O'Neal in their analysis concluding that economies of scale are

present at Harris. *See* Khorana Rep. at 14-18. Additionally, as explained in ¶ 11, *supra*, Harris's expert's regression analysis does not allow him to conclude that the Funds are achieving economies of scale. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

13. Harris prevented the trustees of the Funds from taking economies of scale into consideration when evaluating the Funds' advisory contracts because Harris failed to provide the trustees with adequate information regarding its economies of scale. In fact, Harris never provided the trustee with an actual economies-of-scale analysis. Furthermore, the information Harris provided to the trustees regarding its profitability from managing the Funds was misleading, particularly because Harris's methodology for allocating its costs tended to mask the economies of scale inherent in Harris's business.

Response: This paragraph comprises expert opinion testimony that is not properly included in the Statement. Harris does not dispute that it did not provide the trustees an independent economies of scale analysis, but does dispute that this establishes the fact that it "prevented" the trustees from taking economies of scale into consideration. Harris disputes that the profitability analyses it provided to the trustees were flawed and that its cost allocation methodology masked its economies of scale. *See* sources cited in ¶ 3, *supra*; Khorana Rep. at 10. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

14. Michael Friduss, one of the disinterested trustees attempted his own analysis of economies of scale. His analysis graphed Harris's revenues and

costs and clearly demonstrated that Harris's costs declined as a percentage of revenues as the assets of the Funds grew. However, Harris personnel, including CEO John Raitt, were very critical of the analysis. Harris made some attempt to recreate Friduss's charts, but offered no insight into economies of scale or further assistance in understanding the charts. Ultimately, the trustees (including Friduss) essentially rejected the analysis and drew no conclusions from it. The trustees made no other attempt to determine whether the Funds were experiencing economies of scale and whether such economies of scale were being shared with the shareholders. Nor did the trustees seek assistance from anyone in making such a determination. In fact, although Friduss claimed to have conducted "much research" on economies of scale, he was completely ignorant of widely publicized studies by the SEC and GAO. One disinterested trustee even admitted that he did not consider economies of scale realized by Harris.

Response: Harris does not dispute that trustee Friduss attempted his own analysis of Harris's economies of scale. Harris does dispute that his analysis "clearly demonstrated economies of scale," as these graphs reflected methodological and other errors committed by Friduss. *See* Dep. Tr. of John Raitt, Pls.' Ex B-8, at 255 ("The analysis . . . had several problems with it. There are some basic input errors. There was some errors in methodology and some weaknesses in presentation."); Dep. Tr. of Kristi Rowsell, Pls.' Ex B-11, at 233 ("I remember problems with these graphs having data out of order, for example; and I felt like they were not a fair depiction of the revenues and expense data they were trying to represent."). Harris does not dispute that the trustees rejected the Friduss analysis and drew no con-

clusions from it, that they did not seek assistance from outside parties in making an economies of scale determination, that Friduss was unaware of the SEC and GAO studies and that Reich testified that he did not consider economies of scale.

15. While the fee schedules for the Funds contain breakpoints (mostly nominal), the breakpoints in fee schedules for institutional and sub-advisory clients are set at much lower asset levels, thus providing higher discounts to those clients. The small breakpoints for the Fund were unrelated to actual economies of scale realized by Harris and were set by the trustees without reference to Harris's profitability or costs of providing services. Rather, the trustees looked to irrelevant factors, such as the placement of breakpoints by other mutual fund complexes. In fact, one trustee even conceded that when it came to setting breakpoints, the trustees would have no idea whether breakpoints were set too high to pass on economies of scale.

Response: Harris does not dispute that the breakpoints for the Funds differed from the breakpoints set for institutional and sub-advisory clients. Harris does dispute that the breakpoints for the Funds were unrelated to actual economies of scale realized by Harris. *See* Dep. Tr. of Michael Friduss, Pls.' Ex. B-2, at 183 ("Q: Is it then your intention that that those breakpoints are to capture the economies of scale being attained so that they are passed on to shareholders in some way? A: Yeah, I mean they are intended to capture some economies of scale that – that accrue to the shareholders."). Harris disputes that the trustees set the breakpoints by considering only "irrelevant factors." *See* Dep. Tr. of Marvin Rotter, Pls.' Ex. B-10, at 99 ("I can't absolutely quantify that we are giving the clients the maximum amount

of share of the economies of scale. All I could say is we – we gather as much information as humanly possible to do the best we can."). Harris does not dispute that trustee Friduss testified that he would not know if the breakpoints were set at too high a figure. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

16. In 2002, when the trustees of the Funds considered implementing breakpoints for the Equity and Income Fund, the portfolio manager for the Fund, Clyde McGregor, "strongly opposed the addition of breakpoints" and indicated that he would close the Fund rather than decrease Harris's profitability. The meeting where McGregor's threat to close the Fund was discussed was attended in person by one disinterested trustee (three others participated by phone) and five Harris executives, including John Raitt (CEO of Harris). Thus, Harris personnel outnumbered the disinterested trustees five to four, and the sole trustee who participated in person five to one. Needless to say, no breakpoints were instituted during this contract cycle.

Response: It is undisputed that a meeting occurred at which the possible implementation of breakpoints for the Equity and Income Fund was discussed, as set forth in the minutes of the meeting. However, Mr. McGregor was not in attendance at this meeting and his comments regarding the implementation of breakpoints were conveyed second hand by Mr. Friduss. *See* Pls.' Ex. C-33 at 1-2. Additionally, Harris disputes Plaintiffs' statement that McGregor threatened to "close the Fund;" rather the suggested alternative to implementing breakpoints attributed to him in the meeting minutes was to close the Fund "to new investors," a not uncommon occurrence in the mutual

fund industry. *Id.* at 2. Harris does not dispute the number or identity of the trustees and Harris personnel in attendance at this meeting and does not dispute that no breakpoints were instituted during that particular contract cycle.

17. In 2003, John Raitt (the CEO of Harris) suggested that instituting breakpoints for the Funds would make them "less attractive" to manage and that Harris would "reserve [its] limited investment capacity for [its] higher fee business." Raitt openly admitted at his deposition that Harris "would be likely to pursue growth in other businesses and possibly add additional resources to other businesses at the expense of the funds."

Response: Harris does not dispute that Mr. Raitt participated in discussions with the trustees and Harris personnel regarding the implementation of breakpoints at the Funds. Harris disputes that Mr. Raitt's handwritten notes reflect a general belief that breakpoints make the Funds less attractive to Harris, as the notes were prepared in the context of a specific discussion regarding breakpoints at the Equity and Income Fund. *See* Pls.' Ex C-34. Harris does not dispute that Mr. Raitt made the statement attributed to him at his deposition, but the statement taken in isolation provides insufficient context. Mr. Raitt also stated at his deposition that "at no time have I threatened to take away resources from the – you know, from the Oakmark funds if we weren't making enough money. We've still got a fiduciary obligation to do the best that we can for our shareholders." *See* Dep. Tr. of John Raitt, Pls.' Ex B-8, at 240.

18. Harris refused to implement any breakpoints that would result in an immediate reduction of fees (or concomitant passing on of economies of scale).

Rather, Harris would only agree to breakpoints for future, unrealized asset growth because Harris did not want to reduce its profits, or as one trustee put it at his deposition, Harris's "bottom line." One trustee expressed his belief that Harris would "not accept any reduction of current fees" and indicated that Raitt told him that Harris was "willing to look at lower breakpoints going forward, but nothing that reduces fees as they [currently stood]." Ultimately, the trustees capitulated to Harris as none of the breakpoints added to the fee schedules for the Funds have resulted in current fee reductions.

Response: Harris disputes that Harris could "refuse" to do anything regarding the implementation of breakpoints, as the decision to set fees or institute breakpoints resides with the trustees of the Funds, and these decisions are made following a negotiation with Harris. Harris does not dispute that the trustees may have had certain impressions of these negotiations which they conveyed in their deposition testimony. Nonetheless, Harris submits that none of these impressions is material for the reasons set forth in its briefs.

19. Pursuant to the investment advisory agreements between Harris and the Funds, Harris provides only investment advisory services, including "manag[ing] the investment and reinvestment of the assets of the Fund[s]," and "plac[ing] all orders for the purchase and sale of portfolio securities for the account of the Fund[s] with brokers or dealers." The agreements expressly state that other services "are not within the scope of the duties of the Adviser under th[e] agreement[s]" and that the "Adviser (or an affiliate of the Adviser) may receive [other compensation] from the [Funds] for such services *in addition* to its fee for services as Adviser." Importantly, the

investment advisory agreements do not provide for accounting services, shareholder services, administrative services, or transfer agency services. Rather, these non-investment services are provided under separate agreements pursuant to which the Funds pay additional fees.

Response: Harris does not dispute that the investment advisory agreements state the Funds will manage the investment and reinvestment of Fund assets and place orders for the purchase and sale of portfolio securities. The agreements do not specify what services are included within the management of the investment and reinvestment of Fund assets. Harris does dispute that these agreements provide that it will provide "only investment advisory services," as this is nowhere specified in said agreements. Harris also disputes that the advisory agreements state that other services "are not within the scope of duties of the Adviser under this agreement." This is a misquotation by the plaintiffs, as the agreements actually say "*[s]uch brokerage services* are not within the scope of duties of the Adviser under this agreement." *See* Pls.' Ex C-18 ¶ 3 (emphasis added). Harris does not dispute that the advisory agreement do not explicitly provide for certain accounting services, administrative services or transfer agency services and that the Funds pay separate fees for these service pursuant to various separate agreements.

20. In addition to providing advisory services to the Oakmark Funds, Harris provides advisory services to a variety of non-mutual fund clients, including pension funds, retirement accounts and subadvisory accounts ("institutional accounts"). The advisory services provided to the institutional and subadvisory accounts are virtually identical to the advisory services provided to the Oakmark Funds.

In fact, Harris's research department is managed as a single entity, and the research conducted is used equally by all clients. Indeed, portfolio managers for both the Funds and the institutional accounts are not only given the same research, but attend the same weekly stock selection meetings. There is virtually no difference in the day-to-day management activities between the mutual funds and the institutional accounts, and the same people who manage the institutional accounts contribute to the management of the Oakmark Funds.

Response: Harris does not dispute that it provides advisory services to a variety of non-mutual fund clients. Harris does dispute that advisory services provided to the institutional and subadvisory accounts are "virtually identical" to the advisory services provided to the Funds. At the request of the trustees, the 15(c) materials provided to them each year by Harris describe which of the services provided by Harris to the Funds are *not* provided to Harris's non-mutual fund clients. *See* L.R. 56.1 Stmt. ¶ 24 and sources cited therein. Harris does not dispute that its research department is managed as a single entity and that the same personnel who manage institutional accounts contribute to the management of the Oakmark funds. However, it does dispute that there is virtually no difference in the day to day management activities of the different types of Funds. *See* Dep. Tr. of William Nygren, attached as Ex. 2 to Blais Reply Decl., at 137 ("I am aware that we charge an investment advisory fee that covers what I referred to earlier as a suite of services, the portfolio construction, the shareholder communication, client servicing side of the business. In a mutual fund, it's a broader group of people who are involved in client servicing."). For example, the net asset value of the

Funds is computed on a daily basis; that of the institutional accounts is calculated much less regularly. Additionally, the Funds must be managed to take account the daily inflows and outflows of cash from thousands of individual and dispersed investors. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

21. The portfolio holdings of the institutional accounts are consistent with mutual funds that share the same strategy. For example, during a given time period, institutional accounts in Harris's large cap strategy will contain most of, if not all, the same stocks as the Oakmark Fund. In fact, Harris's standard response to requests for proposals suggests that clients seeking a large cap strategy can invest in either the Oakmark Fund or separate institutional accounts, identifying minimum account size as the only difference.

Response: Undisputed.

22. Any differences between the advisory services provided to the Oakmark Funds and those provided to the institutional accounts are de minimis in terms of their cost to Harris. In fact, even considered in isolation, a conservative estimate of the fully allocated costs (including overhead) of the departmental personnel that provide services to the Funds, but not the institutional accounts, amounts to 1.56 basis points of the Fund assets (0.0156%) (this includes the total costs of the Fund Operations and Fund Accounting Departments). Nonetheless, Harris charges the Funds fees that are 40 to 65 basis points higher than those charged to the institutional accounts. Moreover, an examination of all of Harris's costs shows that Harris's institutional business is more costly to Harris than the Funds in relationship to

assets under management. In fact, out of Harris's 179 fulltime-equivalent employees (FTEs), only 50 FTEs (28%) are dedicated to the Funds, while 129 FTEs (72%) are dedicated to Harris's other clients. The Funds comprise $17.6 billion (48% – almost half) of Harris's $36.5 billion in assets under management. The fully allocated costs (including overhead) of all FTEs who provide services to the Funds is between 2.8 and 6.5 basis points less than the fully allocated costs (including overhead) of all FTEs who provide services to Harris's other clients.

Response: This paragraph comprises expert opinion testimony that is not properly included in the Statement. Harris also submits that Plaintiffs cannot establish issues of fact in reliance upon "rebuttal" expert reports as to which this Court has not granted leave to submit. Harris has not had an opportunity to depose Plaintiffs' experts regarding their rebuttal reports, nor have Harris's experts had an opportunity to test the calculations set forth in these reports or to prepare their own rebuttal reports.

23. Despite the fact that the advisory services Harris provides to the institutional accounts are virtually identical to those provided to the Oakmark Funds, and despite the fact that the institutional business is more costly to Harris than the Funds, the Funds pay advisory fees that are nearly twice as much or more than the fees paid by the institutional accounts. This is so even though the Funds are all much larger than the institutional and subadvisory accounts. If the Oakmark Fund were subject to the same fee schedule as comparable institutional accounts, the effective-fee for the Oakmark Fund would be 35.2 basis points, or 52.8 basis points less than what the Oakmark Fund pays. If the Oakmark Equity & Income Fund were subject to the same fee schedule

as comparable institutional accounts, the effective fee for the Oakmark Equity & Income Fund would be 25.4 basis points, or 47.6 basis points less than what the Oakmark Equity & Income Fund pays. If the Oakmark Global Fund were subject to the same fee schedule as comparable institutional accounts, the effective fee for the Oakmark Global Fund would be 51.3 basis points, or 48.7 basis points lower than what the Oakmark Global Fund pays. If Harris had charged the Funds fees that were comparable to fees charged to similar institutional accounts, the Funds would have saved between $37 million and $58 million during the damages period.

Response: For the reasons stated in the response to paragraph 20 and detailed in Harris's Local Rule 56.1 statement at ¶¶ 23-24, Harris disputes that the advisory services provided to institutional accounts are virtually identical to those provided to the Funds. For the reasons states in the response to paragraph 22, Harris disputes that the institutional business is more costly to Harris than the Funds. Harris does not dispute that the Funds pay advisory fees which are higher than those charged to institutional Funds, but disputes that there are "comparable" institutional funds to which the Funds can be compared, as the institutional funds are provided a different suite of services than the Funds. *See* sources cited in ¶ 20, *supra*. Harris also disputes the Plaintiffs' damages characterization, as this calculation is premised on the mistaken assumption that the Funds were provided the same services as institutional funds and thus should have been charged comparable fees. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

24. For purposes of considering and approving the fees paid by the Funds during the relevant damages period, the trustees of the Funds never received information about the services Harris provided to its other clients or the fees Harris charged to its other clients. The trustees first requested this information on March 31, 2004 (for reviewing fees to be paid in 2005). When Harris finally provided this information, it falsely and misleadingly indicated that Harris provided greater and more costly services to the Funds. Harris failed to point out to the trustees that the Funds pay additional fees to Harris or its affiliates for providing many of the services listed by Harris and failed to inform the trustees that the advisory services Harris provides to the institutional accounts are virtually identical to those provided to the Funds and that the institutional business is more costly to Harris than the Funds.

Response: Harris disputes that the trustees never received information about the services Harris provided to its other clients or the fees Harris charged to its other clients, as Plaintiffs concede in the third sentence of this paragraph that Harris did, in fact, provide such information. Harris does not dispute that the trustees requested this information on the date specified and that Harris provided the information requested. Harris does dispute that the information "falsely and misleadingly indicated that Harris provided greater and more costly services to the Funds," as it is, in fact, true that Harris provided greater and more costly services. *See* Pls.' Ex. C-1. Harris does not dispute that it did not point out in the documents that the Funds paid additional fees to Harris for providing certain services, as trustees had access to copies of the agreements governing such additional services. Harris disputes that there was

any need to inform the trustees that the advisory services provided to the institutional accounts are virtually identical to those provided to the Fund, as this is, in fact, not true, *see* sources cited in ¶ 20, *supra*, or that the institutional business was more costly, *see* response to ¶ 22, *supra*. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

25. Even Harris investment professionals and marketing personnel expressed concern over explaining the fee gap between the Funds and similarly managed institutional accounts. In an email exchange between Bill Nygren, portfolio manager of the Oakmark Fund, and Michael Neary, head of marketing at Harris, Neary stated: "I worry less about the fee gap in sub-advised than I do institutional." Nygren replied: "I'm just worried about trustee relations and maintaining our existing [mutual] fund fees – it would be nice to be able to answer [the question of whether the mutual fund fees are similar to what other large accounts pay] affirmatively .... And I have suggested to Clyde [McGregor, portfolio manger of the Oakmark Equity and Income Fund,] that as a 'premium manager', he should not be offering to manage new accounts at our normal institutional rates." In a follow-up email the next day, Neary suggested that if the Funds are compared to accounts with a "similar strategy," then Harris's defense regarding the fee discrepancy "is weak but not zero." He also suggested that another Fund portfolio manager was "in a more difficult situation" because "[h]is institutional accounts are nearly identical and his fee gap approaches 40 [basis points]."

Response: Harris does not dispute that the specified documents state what they are quoted as stating, but disputes Plaintiffs' sweeping conclusion that

isolated statements in various emails suggest that "Harris investment professionals and marketing personnel expressed concern over explaining the fee gap between the Funds and similarly managed institutional accounts." Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

26. A comparison of the performance of the Funds against the performance of composites made up of institutional accounts with the same strategy shows that for the Oakmark Fund and Oakmark Global Fund, investors in the mutual funds have received less return from their investments than institutional investors. From 1999 to 2004, the Oakmark Fund had an annualized return of 6.40% as compared to 10.69% for the composite. From 1999 to 2004, the Global Fund had an annualized return of 17.7% as compared to 19.4% for the composite. While, over this time period, the Oakmark Equity and Income Fund returned 13.1% compared with 11.1% for the composite, the majority of that out performance came from just two quarters rather than any consistency in the investment process. However, despite the similarity in performance between the Funds and the institutional accounts, Harris charged much higher fees for advisory services to the Funds.

Response: Harris disputes that the comparison of the Funds' performance to that of various institutional composites is a meaningful one. First, the performance of the Funds is reported net of certain expenses, including fees, while that of the institutional composites is reported before expenses are subtracted. Second, the composites do not hold the same securities, or hold them in the same quantity, as the Funds. As a result, any comparison between the two sets of performance figures is simply not an

apples-to-apples comparison, and thus has no probative value.

Moreover, Harris disputes Plaintiffs' implication that the Funds somehow had sub-par returns. For the three year period ended March 31, 2004, the Global Fund generated an average annual return of 22.36% net of fees, the single best performance result of any of the 254 funds in its performance universe, as defined by Lipper. This return was far above its benchmark, the Lipper Global Fund Index, which had an average annual return during that period of 2.31%. *See* L.R. 56.1 Stmt. ¶ 27. The fund's average annual net return over the prior *four* year period[1] was 20.24%, again the single best performance result of any fund in its performance universe for this period, and far above its benchmark, which had an average annual *loss* of 4.8%. *See id.* For the three year period ended March 31, 2004 the Equity and Income Fund generated an average annual return of 12.49% net of fees, the third best performance during that three year period of the 445 funds in its performance universe, and far above its benchmark, the Lipper Balanced Fund Index, which had an average annual return of 3.76%. *See id.* ¶ 25. For the *five* year period ended March 31, 2004, the Equity and Income Fund's average annual net return of 13.91% was the single best performance result of any fund in its performance universe, and far above its benchmark figure of 3.11%. *See id.* For the three year period ended March 31, 2004, the Oakmark Fund generated an average annual return of 6.22% net of fees, giving it a rank of 12 out of 307 funds in its Lipper performance universe, and placing it above

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[1] Shares of the Oakmark Global Fund were first offered for sale on August 4, 1999, so a five year performance figure was not used in the 2004 Lipper report.

its benchmark, the Lipper Large-Cap Value Index, which had an average annual return of 1.43%. *See id.* ¶ 26. For the *five* year period ended March 31, 2004, the fund's average annual net return was 5.29%, giving it a rank of 18 out of 224 funds in its performance universe, and above its benchmark figure of 1.22%. *See id.* Harris does not dispute that it charges advisory to its institutional accounts which are different from those charged to the Funds, but it disputes Plaintiffs' characterization that the fees charged to the Funds are "much higher." Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

27. During the relevant damages period, the Funds paid millions of dollars in commissions to Harris Associates Securities L.P. ("HASLP"), an affiliated broker, for brokerage services. HASLP had no employees, and these brokerage services, including trade aggregation, were actually performed by Harris personnel. However, Harris was already being compensated to provide services such as trade aggregation as part of the advisory agreements with the Funds. Essentially, the Harris traders exercised their discretion to place orders with HASLP by "switching hats" and assuming their role as HASLP brokers. In effect, Harris personnel placed the orders with themselves and received brokerage commissions on top of the advisory fees they were already receiving. Clyde McGregor, a senior portfolio manager at Harris, conceded that Harris's arrangement with HASLP was confusing and difficult to justify. The trustees of the Funds were unaware that HASLP had no employees and that the work was actually performed by Harris personnel.

Response: Harris does not dispute that it paid millions of dollars in commissions to HASLP for broker-

age services. Execution of fund trades through a broker affiliated with the adviser is expressly permitted by Section 17 of the ICA, provided certain conditions are met, and the Funds' investment advisory contracts with Harris expressly authorize Harris to utilize its affiliated broker to execute the Funds' transactions. *See* 15 U.S.C. § 80a-17(e); L.R. 56.1 Stmt. ¶ 35. Pursuant to rules promulgated under Section 17, such "affiliated transactions" are reported to the Funds' independent trustees for their approval. *See* L.R. 56.1 Stmt. ¶ 17. Harris disputes that the deposition testimony of one trustee that he did not know whether the "people doing the actual trading are Harris Associates or some other affiliate of Harris Associates", *see* Pls.' Ex B-14 at 135, establishes that "the trustees of the Fund were unaware that HASLP had no employees and that the work was actually performed by Harris personnel." Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

28. Fees paid to intermediaries who distributed shares of the Funds were paid in part by the Funds. These fees were paid to the intermediaries for both shareholder services and marketing and distribution services. The Funds paid 43% of the fees paid to the intermediaries subject to a cap based on fees paid to the affiliated transfer agent. However, the 43%-split was not based on the actual expenses of the intermediary incurred for shareholder servicing, and the trustees of the Funds made no effort to determine (and often did not understand) what portion of these fees reimbursed intermediary expenses related to marketing and distribution rather than shareholder servicing. Moreover, Victor Morgenstern, who was responsible for setting up the agreements with the intermediaries before he resigned from Harris, did

not know what portion of the intermediary fee applied to marketing and distribution. He just assumed that the transfer agent fees paid to the Funds' affiliated transfer agent reflected a reasonable fee to pay to third-party intermediaries without conducting an inquiry into the actual nature or cost of the intermediary services.

Response: Harris does not dispute that certain fees paid to third-party intermediaries (e.g. Fidelity and Schwab), are paid in part by the Funds, although Harris is not made aware by these intermediaries exactly what services they are providing to their clients. Harris does not dispute that for certain periods the Funds paid 43% of the fees paid to the intermediaries subject to a cap based on fees paid to the affiliated transfer agent. Harris is not aware of the specific services provide by the intermediaries to their clients, nor the specific costs to the intermediaries for providing such services, nor does it have any ability to obtain such proprietary information. Harris does not dispute that Mr. Morgenstern testified at his deposition regarding his understanding of the payments to intermediaries, but does dispute that there was any way he could have "known what portion of the intermediary fee applied to marketing and distribution," as this proprietary information is not made available by these third-party intermediaries. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

29. The Funds paid 43% of the fees paid to intermediaries who distributed shares of the Funds and were reimbursed by Harris to the extent that 43% exceeded what the Funds would have paid to the affiliated transfer agent. However, unbeknownst to the trustees for the Funds, Harris endeavored to

reduce the amount of the reimbursements by using undisclosed accounting methodologies so that the Funds would pay as much as possible. The trustees of the Funds were unaware of these efforts, and at least one trustee conceded [after the fact] that Harris's activities were wrongful.

Response: Harris does not dispute that the Funds paid 43% of certain of the fees paid to certain intermediaries (e.g., Fidelity and Schwab), and that Harris effectively paid any portion thereof to the extent that 43% exceeded what the Funds would have paid to the affiliated transfer agent. Harris does not dispute that the document cited states what it is quoted as stating but does dispute that this establishes "an endeavor by Harris to reduce the amount of the reimbursements by using undisclosed accounting methodologies so that the Funds would pay as much as possible." This is a blatant mischaracterization of this document, and nothing cited by plaintiffs supports this characterization of it. Harris does not dispute that the trustees were "unaware" of such supposed endeavor, as no such endeavor actually existed.

30. As part of a practice known as "soft dollars," Harris spent millions of dollars of Fund assets on commissions during the relevant damages period in return for research products and services that benefited Harris. For instance, for the 12-month period ending September 30, 2004, the Funds paid nearly $3 million in soft dollar commissions. While Harris reported the amount of the soft dollar commissions, it never reported the value of the products and services obtained with soft dollars to the trustees of the Funds. The value of the products and services obtained with soft dollars was approximately $2.3 million. Without the use of Fund assets, Harris

would have had to pay for these products and services out of its own pocket.

Response: Harris does not dispute that it received certain research and related services from third parties that execute brokerage transactions in the Funds' portfolio securities – a practice commonly referred to as "soft dollars." This practice is completely legal and was regularly monitored by the Funds' trustees. Harris does dispute that the $3 million dollars of commissions which it paid to third-party brokerages for their brokerage services can be characterized as "soft dollar commissions." These commissions were paid by the Funds for legitimate brokerage services. The third-party brokerages who received such commissions sometimes provided research products and other services to Harris that were used on behalf of all Harris's clients, including the Funds. Nonetheless, Harris submits that none of these disputes is material for the reasons set forth in its briefs.

31. Prior to January 1, 2001, Morgenstern was a partner and executive of Harris. Effective January 1, 2001, Morgenstern retired from Harris and became a "disinterested" trustee of the Funds as well as Chairman of the Board. At this time, Morgenstern began receiving "deferred" compensation from Harris ("C Plan Compensation") that was subject to reduction based on certain limits associated with Harris's revenues, much of which are derived from the Funds. For example, in 2001 (Morgenstern's first year of eligibility for C Plan Compensation) Morgenstern received less than his targeted amount because Harris's revenues in 2001 were not sufficient to entitle him to the entire $632,125. Other participants in the C Plan who received C Plan Compensation while Morgenstern was a trustee for the Funds include Anita Nagler, Roxanne Martino, Anita Rosenberg,

and Sherwin Zuckerman, all former partners of Morgenstern at Harris.

Response: Undisputed, except that the individuals identified were not legally "partners" of Harris at any relevant time period (as Harris was not a partnership), but were instead employees who were simply referred to internally as "partners."

32. Morgenstern, both while he was a partner at Harris and after he retired and became a "disinterested" trustee of the Funds, maintained very close personal and business relationships with other trustees of the Funds. Morgenstern, Wilner, and Ruder have been close friends and neighbors for many years. They have children who are contemporaries, they have vacationed together on many occasions, and Wilner is a trustee of one of Morgenstern's family trusts. Morgenstern and Wilner formed an investment partnership called Bear East Partners approximately 10 years ago (worth about $200,000 when it was liquidated last year), which traded through Harris and may have invested in common vehicles with current and former Harris partners. Morgenstern and Wilner have also invested together in BioSante, Valor Equity Partners, and real estate, including vacation property in Colorado (worth about $1 million) and property in Wisconsin that they bought for $600,000 and sold in 1999 to a then-partner at Harris for $2.25 million. Morgenstern has invested together with Ruder in BioSante, Valor Equity Partners, and Super Cerca, which Morgenstern introduced to Ruder. Morgenstern has also been close friends with Friduss since 1960, and Friduss' brother, Jarvis, was Morgenstern's personal accountant for several years. Morgenstern personally recommended Wilner, Ruder, and Friduss as "disinterested" trustees of the Funds.

Response: Undisputed, except that Mr. Morgenstern was not legally a "partner" of Harris at any relevant time period (as Harris was not a partnership), but was instead an employee who was simply referred to internally as a "partner."

33. After Morgenstern became a "disinterested" trustee, he maintained close personal and business relationships with Harris. For example Morgenstern is a close friend of Sherwin Zuckerman (a former Harris partner who retired a year after Morgenstern) and has had numerous common investments with him, including, among others, BioSante and Valor Equity Partners. As detailed below, other Harris partners also invested in BioSante and Valor Equity Partners. In addition, Morgenstern has invested millions of dollars in (and received discounted fees on) hedge funds managed by Harris Alternatives (an affiliate of Harris), revenues of which contribute to the C Plan Compensation.

Response: Undisputed, except that the individuals identified were not legally "partners" of Harris at any relevant time period (as Harris was not a partnership), but were instead employees who were simply referred to internally as "partners."

34. Morgenstern has been a director and substantial shareholder in a company called BioSante Pharmaceuticals, Inc., since the late 1990s. Morgenstern has over $2 million invested in BioSante. Others who invested in BioSante while Morgenstern was still a partner at Harris include at least two of his partners (Zuckerman and Anita Nagler – also C Plan participants), three of the disinterested trustees for the Funds (Wilner, Ruder, and Rotter), and one trustee's brother, all of whom learned about BioSante from Morgenstern.

Response: Undisputed, except that the individuals identified were not legally "partners" of Harris at any relevant time period (as Harris was not a partnership), but were instead employees who were simply referred to internally as "partners."

35. In 2002 Morgenstern founded Valor Equity Partners, a private equity investment partnership that attracted about 30 investors. Morgenstern has invested over $2 million in Valor, and his son is employed by Valor. Three partners at Harris (Nagler, Roxanne Martino and Anita Rosenberg) and one former partner (Zuckerman) invested in Valor. Three disinterested trustees of the Funds (Wilner, Ruder, and Rotter) also invested in Valor. All of these co-investors were invited into Valor by Morgenstern.

Response: Undisputed, except that the individuals identified were not legally "partners" of Harris at any relevant time period (as Harris was not a partnership), but were instead employees who were simply referred to internally as "partners."

36. Other trustees with close personal and business relationships with Harris personnel include Rotter and Reich. Rotter has been friends with Zuckerman for 20 years, was (and is) a client of his, and Zuckerman is married to Rotter's cousin. Rotter and Zuckerman have invested together in numerous vehicles, including BioSante and Valor Equity Partners. Zuckerman recommended Rotter as a trustee of the Funds. Reich has provided legal representation for former and current Harris partners and has maintained a close relationship with Robert Levy (a Harris partner), who manages an IRA for Reich. Levy recommended Reich as a trustee of the Funds.

Response: Undisputed

37. Several of the disinterested trustees of the Funds were aware that Morgenstern received compensation from Harris but nonetheless approved of his serving as a "disinterested" trustee subject to the false notion that Morgenstern had "severed all his formal and financial ties to the advisors and was truly independent." In addition, the trustees were aware of the other conflicts involving Morgenstern.

Response: Harris admits that several trustees were aware that Morgenstern received compensation from Harris. For the reasons set forth in Harris's briefs, Harris denies that this fact disqualified Morgenstern from serving as a disinterested trustee. The trustees were advised by their independent legal counsel that Mr. Morgenstern "would no longer fall within the statutory definition of 'interested' trustee unless the Securities and Exchange Commission, after an opportunity for a hearing, were to issue an order determining that Mr. Morgenstern prospectively would be an interested trustee by reason of having had a material business relationship with [Harris] . . . ." The trustees' counsel further advised that "[e]ven if Mr. Morgenstern were subsequently determined to be an interested trustee, that determination would not impair the validity of action taken by Mr. Morgenstern during the period that he was a non-interested trustee. Moreover, even at the present time, the board has a super-majority (seven out of nine) non-interested trustees." *See* Minutes of the Meeting of the HAIT Board of Trustees, dated Jan. 17, 2001, attached as Ex. 9 to Decl. of Brian R. Blais, dated Oct. 10, 2006, at HA 0010798 – HA 0010801. In light of this legal advice of the lack of an SEC determination of disinterestedness, Harris denies Plaintiffs' assertion that the notion Morgenstern had "severed all his formal and financial ties to the advi-

sors and was truly independent" is false and denies that any of the relationships described by Plaintiffs can be properly characterized as "conflicts."

38. Neither Morgenstern's C-Plan compensation nor his investments in hedge funds managed by a Harris affiliate were ever disclosed in the registration statements for the Funds.

Response: Undisputed.

Respectfully submitted,

HARRIS ASSOCIATES, L.P.

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Dated: October 24, 2006

EXHIBIT 3

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

EXPERT REPORT OF THOMAS M. BLAKE

April 17, 2006
(Revised as of May 2, 2006)

* * * * *

2. During the Relevant Period, HALP's managerial accounting system was monitored, maintained and assessed on a consistent basis. The managerial accounting system performed financial analyses in a reasonable manner, fulfilled its intended purpose of producing decision making information, and was supported by reasonable assumptions and documentation.

A. HALP employed significant effort in formulating the metrics applied in its managerial accounting system. These metrics are sum-

marized in the annual term sheets ("Term Sheets").

HALP developed a methodology and implemented it within its managerial accounting system to map costs to the products and services that they support. HALP spent a significant effort to perform annual evaluations and updates of its managerial accounting and cost allocation methodology. The accounting department generally began the update process in December of each fiscal year. The update reflected year-to-date costs incurred and other anticipated costs. It assessed HALP's cost allocation model for identification of direct expenses, which were charged to lines of business ("LOBs") and/or products,[18] and shared and indirect expenses, which were allocated based upon financial, business and market-driven metrics. With respect to shared and indirect expenses, HALP used the annual update process to assess where and how costs would be expected to be consumed by the LOBs and products offered by the business for the coming year. The assessment required input from numerous financial and non-financial sources, including system reports and HALP personnel. It was a forward-looking process that sought and relied upon input from many executives, managers and financial personnel.

* * * * *

[18] Products include funds such as the Oakmark Funds.

3. **Based upon my review of HALP's managerial accounting system and the resulting 2003 Profitability Analysis, it is my opinion that HALP utilized a reasonable methodology and had a supportable basis for determining the costs charged to the Oakmark Funds.**

   A. There are numerous managerial accounting and cost allocation methodologies that can be employed to charge costs on a reasonable basis.

      Managerial accounting systems are not a "one size fits all" methodology. There are many options available to businesses regarding the managerial accounting system that will accommodate the needs and requirements of that business. Managerial accounting systems offer flexibility in their design and output thereby allowing numerous reasonable methods to charge costs to products and services. To demonstrate this, I considered alternatives using high-level metrics, other than those used by HALP for charging costs. Two of these alternatives are described below:

      i. Allocation based on estimated employee time

         HALP surveys its employees annually to estimate the time spent in each LOB. One such analysis prepared in March 2004 by HALP estimated time spent by each employee on the Oakmark Funds. Based on this analysis it was determined that approximately 60% of the full-time equivalent employees in LOBs 200 and

400 dedicated their time to the Oakmark Funds.[47]

I analyzed the salaries, benefits and bonuses paid to the employees of HALP who worked on the Oakmark Funds, including those employees referred to as "partners."[48] In this analysis I also included an allocation of expenses associated with deferred payments made to former employees[49] based upon the current "partner" time allocated to the Oakmark Funds as a percent of total "partner" time. This hypothetical allocation accounted for approximately 79% of the compensation and benefits related expenses charged to the Oakmark Funds in the 2003 Profitability Analysis.[50]

If one were to allocate additional costs such as corporate taxes and a reasonable return on capital, almost all of the costs charged to the Oakmark Funds would be explained. This is important because human capital is HALP's largest asset and accounts for $112.0 million out of $153.5 million of 2003 expense.[51]

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[47] Refer to Exhibit 1 to this report.

[48] "Partner" compensation was based upon their W-2 filing for 2003.

[49] These former employees were referred to as "partners" during their tenure with HALP.

[50] Refer to Exhibits 1, 1a and 1b to this report.

[51] Harris Associates LP Actual v. Budget for the Twelve Months Ending December 31, 2003 (HA0009830). Compensation of $112.0 million is calculated based on adding $16.8 million for salaries, $6.5 million for bonuses and $88.7 million for

ii. Allocation of cost based on AUM[52] or AUM Growth[53]

There are numerous other methods for allocating costs charged to the Oakmark Funds. AUM and AUM Growth are two of these alternative metrics.

AUM

With respect to AUM, HALP had approximately $46.2 billion assets under management as of December 31, 2003. The Oakmark Funds accounted for $22.6 billion of these assets, which is approximately 48.9% of the total HALP balance.[54]

Using AUM as the basis for charging costs to the Oakmark Funds, I can account for 94.5% of the costs actually charged to the Oakmark Funds and reported in the Profitability Analysis which was provided to the Harris Associates Investment Trust ("HAIT") Board of Trustees.[55] The following chart demonstrates

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deferred and discretionary compensation. Total expense of $153.5 million is calculated by adding $64.8 million for expense prior to deferred and discretionary compensation and $88.7 million for deferred and discretionary compensation.

[52] AUM is defined as assets under management.

[53] AUM Growth is defined as growth in AUM which includes the net increase/decrease in cash flows to the fund and market gains/losses.

[54] See Exhibit 2 and Harris Associates L.P. AUM Analysis (HA_N000000003.xls)

[55] Harris Associates L.P. Adviser's Profitability Analysis Related to the Harris Associates Investment Trust for the Year Ended December 31, 2003 (HA0000458-HA0000463)

the cost allocation process and the calculation of our coverage ratio.[56]

* * * * *

D. Mr. Lamb mischaracterized the appropriate accounting treatment of "C" and "D" plan compensation paid to the employees referred to as "partners."

Mr. Lamb stated in his report that "most of the C and D pools should be excluded from the expenses in the profitability reporting as they do not represent a reasonable expense of Harris [HALP] and instead represent profits paid to the partners."[85] I disagree with this assertion for the following reasons:

i. The audited financial statements for HALP reflect compensation as an expense of the company, not profit allocation to the "partners."[86]

ii. The HALP employees referred to as "partners" do not own stock or an interest in HALP. HALP, in fact, is owned by CDC IXIS Asset Management. The employees referred to as "partners" participate in deferred and discretionary compensation pools.

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[56] Coverage ratio is defined as the percentage of estimated expenses charged to the Oakmark Funds in comparison to the actual expenses charged to the Oakmark Funds. The actual expenses charged to the Oakmark Funds was reported to the HAIT Board of Trustees.

[85] Expert Report of James D. Lamb dated January 30, 2006, p. 14.

[86] Harris Associates L.P. and Subsidiaries Consolidated Financial Statements for the years ended December 31, 2003 and 2002. (HA0005463-HA0005478)

iii. The HALP employees referred to as "partners" receive Form W-2s, not Schedule K-1s for tax purposes. Schedule K-1s are required for partnerships. The employees referred to as "partners" have income tax withholding, social security deductions, health care benefits and other indicia of employees rather than true partners.

* * * * *

/s/ THOMAS M. BLAKE
Thomas M. Blake
April 17, 2006
(Revised as of May 2, 2006)
Date

EXHIBIT 4

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

No. 04 C 8305

JERRY N. JONES, ET AL.,
Plaintiffs,

v.

HARRIS ASSOCIATES L.P.,
Defendant.

EXPERT REPORT OF AJAY KHORANA, Ph. D.

May 10, 2006

* * * * *

39. The results of the regression are consistent with the observed closures of several of the Oakmark funds. The academic literature shows that funds are closed to new investors as they grow larger, an action consistent with the exhaustion of economies of scale with higher levels of output.[20] Five out of the six Oakmark funds, including two out of the three Funds, are closed to new third-

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[20] See, for example, Chen, J., et al, "Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization," *The American Economic Review* Vol. 94, No. 5, 2004, pp.1276-1302; Perold, A. and R. Salomon, "The Right Amount of Assets under Management," *Financial Analysts Journal*, May-June 1991, pp. 31-39.

party investors.[21] The closure of several Oakmark funds in recent years is consistent with concerns about diseconomies of scale.

40. Pomerantz performed a rudimentary fund-level cost analysis of economies of scale in the Funds and concluded that there are economies of scale. Aside from the fact that his model is seriously flawed, as discussed in Section V.B, when correctly interpreted, his model produces an economies of scale estimate of 0.93, showing a very high degree of responsiveness of costs with respect to AUM. Taking into consideration the statistical uncertainty of that estimate, one cannot say that the estimate is different from one; i.e., there are no significant economies of scale.[22]

D. Sharing of Economies of Scale – Declining Level of Fees as AUM has Grown

41. To the extent that there are economies of scale, they can be shared with investors by introducing breakpoints or reducing fees, or both. As described above, and illustrated in Exhibits 6A-6C, the fees of the Funds have been declining since 1999 and are currently lower than the median fees of their respective peer groups.

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[21] Some of these remain open to direct investors. Also note that this does not include the Oakmark Small Cap Fund, which was liquidated in September 2004.

[22] Pomerantz Report, Chart 7, p. 14. For a detailed description of the steps, see Appendix D.

V. SHORTCOMINGS OF PLAINTIFFS' REPORTS

A. Edward S. O'Neal

1. *O'Neal's Economies of Scale Analyses are Flawed*

54. As noted above, O'Neal recognizes that "economies of scale exist when the average *cost* of producing a good or service declines as more of the good or service is produced."[35] However, he then relies heavily on expense/fee data to demonstrate evidence of economies of scale. Using expense/fee data, it is impossible to separate economies of scale from investor demand for low-fee funds. Therefore, what he cites as evidence of economies of scale may simply be that investors prefer low-fee funds. A finding that large funds have lower fees is consistent with factors other than scale, such as investor preferences for lower-fee funds and/or other fund attributes.

55. O'Neal's assertion that "[l]arge firms in some industries are inherently more efficient than small firms"[36] ignores the fact that economies of scale are often exhausted and turn into diseconomies of scale (e.g., average cost increases as more of the good or service is produced) as firms grow. This restrictive assumption is also reflected in his focus on Vanguard's fees, which he claims are a good proxy for actual costs. Aside from the fact that economies of scale should be estimated using cost data, O'Neal also uses a simplistic model that does not allow for the "U-shape" curve typically associated with

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[35] O'Neal Report, p. 1.

[36] O'Neal Report, p. 1.

average costs. Thus, he does not allow for the possibility of diseconomies of scale. Furthermore, because Vanguard is a non-profit entity with a focus on index funds, it is not a good proxy for costs of a complex like Harris.

56. In addition to using incorrect data and a restrictive functional form, O'Neal's analysis is also flawed because it considers AUM as the only independent variable affecting fees. He does not control for any other factors that affect fees. In a fund-level analysis such as O'Neal purports to do, one must, at a minimum, control for differences in investment objectives/style that affect fees. There is a well-documented literature, including O'Neal's own work and the ICI Study that he cites, which highlights the importance of controlling for other factors when analyzing scale.[37] My own analysis of economies of scale at the complex level includes a number of control variables, such as input prices, revenues from advisory fees, assets in mutual funds, investment objective, and assets by distribution channel.

57. In attempting to study economies of scale for Oakmark, in his only cost-based analysis, O'Neal exaggerates his conclusions by ignoring an important change in accounting pre- and post-2000. He bases his analysis on Harris's Domestic Mutual Fund unit only (and does not

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[37] See, for example, Gao, X., M. Livingston, and E.S. O'Neal, "The Sources of Economies of Scale for Domestic Equity Mutual Fund Fees," April 2005 working paper. Rea, J.D., B.K. Reid, and K.W. Miller, "Operating Expense Ratios, Assets, and Eco-nomies of Scale in Equity Mutual Funds," ICI Perspective, Vol. 5, No. 5, December 1999.

explain why he does so). However, approximately 50 percent of the AUM of Oakmark Global Fund is managed by portfolio managers in the International Group. More importantly, the income statement for the Domestic Mutual Fund unit that he uses in his analysis appears to include costs for the International Group for 1999 and 2000.[38] Thus the cost data in the pre-2000 period are not comparable to the data in post-2000 period. What O'Neal identifies as economies of scale may be nothing more than a change in accounting procedure. Because my analysis examines Harris as a complex, the allocation of costs to domestic or international units does not affect my results.

58. O'Neal simply asserts that his analyses demonstrate economies of scale, without conducting any statistical test to determine whether the Funds, or Harris as a complex, actually experience economies of scale and, if so, the exact magnitude of those scale economies.

59. Finally, O'Neal makes no attempt to demonstrate the extent to which, if economies of scale do exist, they are passed to shareholders in the form of lower fees. As shown in Exhibit 9, Oakmark fees actually dropped faster than costs as AUM grew. O'Neal claims that fees do not increase at the same pace as assets because "the sub-advised products generate lower fees for Harris" and "the portion of assets under management that were in sub-advised products

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[38] Based on my review of documents produced in this matter (HA 0009830-833, HA 0138326-330, HA 0138341-8357) as well as on a conversation with Kristi Rowsell, April 10, 2006.

increased substantially" between 2000 and 2003.[39] Even after taking this increase in sub-advised AUM into consideration, however, Harris's revenues in bps for the mutual funds were declining. Furthermore, O'Neal does not acknowledge that, because sub-advised funds are less costly to manage for the reasons described above, this shift could also account for the reduction in per unit costs.

2. *O'Neal Fails to Recognize Differences across Different Types of Accounts*

60. O'Neal states that the services provided to institutional and mutual fund shareholders are virtually identical. He further states that the "mutual funds are all much larger than the institutional accounts to which they are compared. Since larger investors are generally able to obtain more favorable fee schedules, it is reasonable to expect that the funds could obtain schedules at least as favorable."[40] However, as discussed above in Section IV, the services provided to institutional and retail mutual fund customers are different, and it is not reasonable to expect that the Funds could obtain the same fee schedules as institutional clients. Harris's CFO Kristi Rowsell pointed out in deposition testimony many of the differences in the services provided to the different types of accounts. For example, the Oakmark funds have a daily net asset value and Harris "ties in that net asset value every day." Harris does not provide daily net asset value calcula-

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[39] O'Neal Report, pp. 15-16.

[40] O'Neal Report, p. 18.

tions for any non-Oakmark accounts."[41] The different services provided to the different types of products were also described to the Board of Trustees,[42] as discussed above in Section IV.

B. Steve Pomerantz

1. *Pomerantz Commits Serious Errors in his Economies of Scale Analysis*

61. Pomerantz states that his analysis shows the existence of scale but the results of his empirical analysis, if interpreted correctly, show that his conclusion is incorrect. In fact, his scale analysis is flawed conceptually, in its use of data and use of inappropriate functional form, as well as in his misinterpretation of the result.

62. Pomerantz purports to examine the presence of economies of scale by examining the relationship between "advisory costs and assets under management."[43] He claims to base his analysis on changes in costs, but commits two serious errors in his calculations. First, he uses the wrong lines in Harris's income statement to calculate costs;[44] and, second, he uses AUMs from an internal Harris document[45] that were incorrect, as pointed out by Ms. Rowsell in her deposition.[46] Pomerantz calculates the advisory costs by "subtracting the amount of Discretionary Compensation line item from the Subsidi-

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[41] Rowsell Deposition, June 15, 2005, pp. 266-72.

[42] I have described these differences in details in Section IV.A of this report.

[43] Pomerantz Report, p.13.

[44] HA 0000459.

[45] HA 0009245.

[46] Rowsell Deposition, June 15, 2005, pp. 232-236

ary Level Expenses."[47] However an examination of his work papers reveals that he actually subtracted "Discretionary Compensation" from "Profit Margin Before Marketing and Parent Level Exp;" this results in a completely erroneous estimate of advisory costs.

63. Pomerantz's model is also conceptually flawed because it assumes that economies of scale are inexhaustible and does not allow for the fact that economies of scale could be different for funds of different size. This is inconsistent with the fact that fund advisors regularly close funds that become too large. Pomerantz inaccurately states that "[p]ortfolio managers, analysts, technologists and support staff required to manage funds remain relatively fixed regardless of the amount of assets being managed."[48] This is at odds with the deposition testimony of Mr. Nygren who stated that, as the Oakmark fund assets grow, "we have to apply a higher level of talent to those portfolios to maintain the performance that we hope to achieve for our shareholders."[49] Furthermore, a number of academic articles have found diseconomies of scale with increasing portfolio size due to greater price impact and market liquidity costs for larger portfolios.[50] Moreover, Pomerantz's analysis is based on only six data

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[47] Pomerantz Report, p. 13.

[48] Pomerantz Report, p. 4.

[49] Nygren Deposition, November 17, 2005, p. 94.

[50] See, for example, Chen, J. et al., "Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization," *The American Economic Review*, Vol. 94, No. 5, December 2004, pp. 1276-1302.

points, which is insufficient to provide robust results, as reflected in the fact that his coefficient is statistically insignificant[51] and that 63 percent of the variation in costs is unexplained by his model ($R^2 = 0.37$).[52] Similar to O'Neal's analysis, he too fails to control for any other factors, unrelated to AUM, that could influence costs.

64. Finally, he misinterprets his results as showing significant economies of scale at the fund level. When correctly interpreted, his model produces an economies of scale estimate of 0.93, showing a very high degree of responsiveness of costs with respect to AUM. Taking into consideration the statistical precision of that estimate, one cannot say that the estimate is different from one; i.e., there is no evidence of economies of scale.[53]

65. Pomerantz opines that fees for the Funds are not reasonable, but does not clearly define the criteria he used to make that determination. He does not examine the extent to which fees have declined, along with a decline in underlying costs. As noted above and as shown in Exhibits 6A through 6C, Oakmark has shared economies of scale, to the extent they exist, with fund shareholders via a reduction in fees.

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[51] Pomerantz does not report the statistical significance of the regression estimates and acknowledged the insignificance in his deposition testimony. Pomerantz Deposition, p. 185.

[52] Pomerantz Report, Chart 7, p. 14.

[53] Pomerantz Report, Chart 7, p. 14. For a detailed description of the steps, please see Appendix D.

66. Pomerantz's fee analysis focuses on one part of the fee, the "advisory fee," which he states is the cost of "portfolio managers, analysts, traders, required technology, and technical and staff support for advisory functions."[54] But, as I have described above, mutual fund complexes are selling an integrated product – portfolio management combined with other services. Thus, analyzing a single component of the total price is economically irrelevant.

67. Like O'Neal, many of Pomerantz's conclusions are based on comparisons to the Vanguard complex. Also like O'Neal, he makes no attempt to distinguish between the alternative hypotheses of investors seeking out low-cost investment vehicles and fees falling as a result of economies of scale, and does not account for other factors such as investment objective, active management and/or changes in production technology, that can affect fees. Furthermore, as I have explained in paragraph 55, Vanguard is not an appropriate benchmark for complexes like Harris.

2. *Pomerantz Incorrectly Assumes that Retail Mutual Fund and Institutional Shareholder Costs Are Identical*

68. Like O'Neal, Pomerantz claims without basis that services provided to institutional and retail mutual fund shareholders are identical.[55] He ignores the differences in services offered to institutional versus retail clients, and/or the different valuations that institutional and

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[54] Pomerantz Report, p. 4.

[55] Pomerantz Report, p. 14.

retail clients place on the services offered by the adviser. As mentioned before and as shown in Exhibit 10, there are important differences in services across these two client groups.

This report in the case of JERRY N. JONES, et al., v. HARRIS ASSOCIATES, L.P., is respectfully submitted.

/s/ AJAY KHORANA
Ajay Khorana
May 10, 2006

PETITIONER'S BRIEF

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(6)

No. 08-586

FILED
JUN 10 2009
OFFICE OF THE CLERK
SUPREME COURT, U.S.

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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QUESTION PRESENTED

Congress enacted the Investment Company Act of 1940 to mitigate the conflicts of interest inherent in the relationship between investment advisers and the mutual funds they create and manage. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984). Section 36(b) of that Act imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services" and authorizes fund shareholders to bring a claim for "breach of [that] fiduciary duty." 15 U.S.C. § 80a-35(b). The Act further provides that, in such an action, "approval by the board of directors" of the fund is not conclusive, but "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.* § 80a-35(b)(2). The question presented is:

Whether a shareholder's claim that the fund's investment adviser breached its fiduciary duty by charging an excessive fee – more than twice the fee it charged to funds with which it was not affiliated – is cognizable under § 36(b), even if the shareholder does not show that the adviser misled the fund's directors who approved the fee.

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INTRODUCTION

This case involves the conflicts of interest arising from the close relationship between investment advisers and mutual funds created and run by those advisers. When an investment adviser seeks compensation for services it provides to the mutual fund, the adviser's incentive to maximize its income conflicts with its fiduciary duty to the funds to maximize their return.

Congress and this Court have long recognized "the potential for abuse inherent in the structure" of mutual funds. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984). To protect investors from such abuse, Congress enacted the Investment Company Act of 1940 ("ICA" or "Act"). Several decades of practice under the ICA, however, convinced Congress that investment advisers continued to charge their funds excessive fees for investment-advisory services, despite structural safeguards in the original ICA. In 1970, Congress added § 36(b) to the Act to impose on investment advisers "a fiduciary duty with respect to the receipt of compensation for services" and to create a right of action for "breach of [that] fiduciary duty." 15 U.S.C. § 80a-35(b).

Because the term "fiduciary duty" derives from the common law, this Court infers that Congress intended to incorporate its settled meaning. A fiduciary entering into a transaction with the person to whom it owes the fiduciary duty must comply with two basic requirements. First, the fiduciary must fully and accurately disclose all material facts relating to the transaction. Second, the transaction must be fair to the one to whom the duty is owed, including being comparable to an arm's-length deal. Interpreting § 36(b) to incorporate those familiar common-law

principles gives meaning to the text Congress enacted and comports with the statute's purposes.

The Seventh Circuit announced a rule of law that an adviser charging excessive fees for advisory services is not liable for breach of fiduciary duty under § 36(b) unless the adviser also misled the fund's board of directors in obtaining their approval of the compensation. *See* Pet. App. 8a-9a. The court adopted that standard even though § 36(b) expressly provides both that approval of the fee by the fund's directors "shall be given such consideration by the court" only as "deemed appropriate under all the circumstances" and that an investor need not "allege or prove that any defendant engaged in personal misconduct." 15 U.S.C. § 80a-35(b)(1)-(2). The court also brushed aside evidence that the fees charged in this case were approximately twice what the investment adviser charges for comparable services in arm's-length transactions with clients it does not control. *See* Pet. App. 6a; *see also id.* at 39a (Posner, J., dissenting from denial of rehearing). The Seventh Circuit reached that result by relying on policy considerations inconsistent with the Act's text and history. The judgment below therefore should be reversed and the case remanded for further proceedings.

OPINIONS BELOW

The court of appeals' opinion (Pet. App. 1a-14a) is reported at 527 F.3d 627. The district court's opinion (Pet. App. 15a-33a) is not reported but is available at 2007 WL 627640.

JURISDICTION

The court of appeals entered its judgment on May 19, 2008, and denied a petition for rehearing on August 8, 2008. *See* Pet. App. 34a-43a. The petition for a writ of certiorari was filed on November 3, 2008,

and was granted on March 9, 2009 (129 S. Ct. 1579). This Court's jurisdiction rests on 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

Relevant provisions of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, are reproduced at Pet. App. 44a-64a.

STATEMENT

A. Statutory and Regulatory Background

1. The funds at issue here are open-end investment companies registered under the ICA – more commonly known as mutual funds. Mutual funds are "typically created and managed by a pre-existing external organization known as an investment adviser." *Daily Income Fund*, 464 U.S. at 536 (citing *Burks v. Lasker*, 441 U.S. 471, 481 (1979)). Investment advisers form mutual funds because they "hope to profit from providing management services to them."[1] The adviser "generally supervises the daily operation of the fund and often selects affiliated persons to serve on the [fund]'s board of directors." *Id.* The relationship between a fund and its adviser is thus "fraught with potential conflicts of interest." *Id.* (internal quotation marks omitted).

In 1940, Congress enacted the ICA to mitigate those conflicts of interest. *See Burks*, 441 U.S. at 480-81; 15 U.S.C. § 80a-1(b)(2) (declaring that "the national public interest and the interest of investors are adversely affected" when mutual funds are managed "in the interest of . . . investment advisers," rather than shareholders). Congress imposed a number of structural safeguards on the industry. Specifically, "Congress established a scheme that

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[1] *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337, at 127 (1966) ("SEC Report").

regulates most transactions between investment companies and their advisers, 15 U.S.C. § 80a-17; limits the number of persons affiliated with the adviser who may serve on the fund's board of directors, § 80a-10; and requires that fees for investment advice and other services be governed by a written contract approved both by the directors and the shareholders of the fund, § 80a-15." *Daily Income Fund*, 464 U.S. at 536-37.

Congress, regulators, and scholars continued to monitor the mutual-fund industry as it grew exponentially in the ensuing decades.[2] In 1958, the Securities and Exchange Commission ("SEC") charged the University of Pennsylvania's Wharton School of Finance and Commerce with producing a study on the industry. *See A Study of Mutual Funds*, H.R. Rep. No. 87-2274 (1962) ("Wharton Report"). The Wharton Report, submitted to the SEC and Congress in August 1962, found that "investment advisers often charged mutual funds higher fees than those charged the advisers' other clients and further determined that the structure of the industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation." *Daily Income Fund*, 464 U.S. at 537 (citing Wharton Report 34). The Wharton Report explained that "the lower rates charged other [non-mutual fund] clients have little to do with differences in expenses." Wharton Report 493. Rather, the "principal reason for the differences

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[2] *See* SEC Report, Letter of Transmittal at vii ("[N]et assets [of mutual funds] increased from $450 million at the end of 1940 to about $38.2 billion at June 30, 1966. . . . In 1940 less than 300,000 Americans held mutual fund shares. By the end of 1965 there were more than 3½ million mutual fund investors.").

in rates" was that "competitive factors which tend to influence rates charged other clients have not been substantially operative in fixing the advisory fee rates paid by mutual funds." *Id.* at 493-94. The Wharton Report also concluded that the unaffiliated directors mandated by the ICA were "of restricted value as an instrument for providing effective representation of mutual fund shareholders in dealings between the fund and its investment adviser." *Id.* at 34, *quoted in Daily Income Fund*, 464 U.S. at 537.

The Wharton Report prompted an SEC investigation, resulting in a report to Congress in December 1966. The SEC's report found that the typical mutual fund managed by an external investment adviser paid "substantially higher" fees for advisory services than did pension plans and other individual and institutional non-fund clients. SEC Report 11; *see id.* at 114-18, 119-21. The Commission attributed that disparity to the captive structure of the typical mutual fund: while investment advisers engage "in active competition with each other for the accounts of pension and profit-sharing plans and other nonfund advisory clients," they "seldom, if ever, compete with each other for advisory contracts with mutual funds." *Id.* at 126.[3]

The SEC further observed that investment advisers were generally compensated on the basis of a fixed percentage of the fund's assets, without regard

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[3] *See also* SEC Report 12 ("The ability of unaffiliated directors to bargain at arm's length is seriously hampered because they are seldom free as a practical matter to terminate a long established management relationship solely because of differences over fee rates. Under these circumstances, the essential element of arm's length bargaining – the freedom to terminate negotiations and to bargain with other parties – is lacking.").

to services rendered or actual expenses. *See id.* at 89. It found that "increases in the assets of a fund do not lead to a commensurate increase in the cost of furnishing it with investment advice and other managerial services." *Id.* at 94. The SEC concluded that, "as a fund's assets grew, this form of payment" – a percentage of net assets – "could produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio." *Daily Income Fund*, 464 U.S. at 537 (citing SEC Report 94, 102). The SEC further noted that, in response to "pressures generated by the Wharton School Study and the pendency of stockholder litigation," some advisers had instituted fee reductions as assets exceeded a certain level (now commonly referred to as "breakpoints"), but found that "these reductions are not substantial in the light of the increases in fund assets." SEC Report 102.

The SEC also concluded that "lawsuits by security holders challenging the reasonableness of adviser fees had been largely ineffective due to the standards employed by courts to judge the fees." *Daily Income Fund*, 464 U.S. at 537 (citing SEC Report 132-43). Relying on the statutorily required approval of the adviser's contract by unaffiliated directors and shareholders, courts required plaintiffs to show "a 'waste' of corporate assets," meaning that fees could be challenged only if they were "unconscionable" or "shocking." SEC Report 12, 142; *see Daily Income Fund*, 464 U.S. at 540 & n.12. Under federal law, courts denied recovery unless investors could show a "gross abuse of trust." SEC Report 143; *see Daily Income Fund*, 464 U.S. at 540 & n.12.[4]

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[4] Congressional testimony echoed the SEC's criticism of the prevailing legal standards. For example, Judge Henry Friendly described the "waste" standard as requiring investors to prove

2. After considering a broad range of information, Congress enacted the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413. Recognizing that structural safeguards alone would not protect investors and cognizant of the inadequacy of existing legal standards for challenging excessive adviser fees, Congress added § 36(b) to the ICA. Section 36(b) imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). It also grants shareholders a private right of action. *Id.* Congress specified that, in a shareholder suit under § 36(b), director approval of the adviser's compensation would not be conclusive but, rather, "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.* § 80a-35(b)(2). Section 36(b) further provides that it is "not . . . necessary to allege or prove that any defendant engaged in personal misconduct" and that the plaintiff has "the burden of proving a breach of fiduciary duty." *Id.* § 80a-35(b)(1).

The 1970 amendments also strengthened the ICA's structural protections by requiring that at least 40% of a fund's directors be persons who are not "interested" in the adviser. *Id.* § 80a-10(a); *id.* § 80a-2(a)(19)(B)(iii). The Act as amended requires that a majority of the "noninterested" (or disinterested) directors annually approve the adviser's compensation agreement "at a meeting called for the purpose of voting on such approval." *Id.* § 80a-15(c).

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the fee was "unreasonably unreasonable" and the federal standard as requiring proof that the compensation was "excessively excessive." *Mutual Fund Amendments (Part 1): Hearings Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. 794-95 (1969) ("1969 Hearings").

B. Proceedings Below

Petitioners own shares in several mutual funds – the Oakmark Fund, the Oakmark Equity & Income Fund, and the Oakmark Global Fund – all of which are part of the Oakmark family of funds. Respondent Harris Associates serves as the investment adviser for the Oakmark funds. *See* Pet. App. 1a. Harris created the funds, manages their daily operations, and provides the funds' office space and equipment. *See id.* at 39a-40a. In addition, Harris selected each member of the funds' joint board of trustees. *See* JA122-23. The Oakmark funds are thus "controlled" or "captive" mutual funds – exactly the type of fund that Congress had in mind when it enacted the ICA and the 1970 amendments. Pet. App. 39a-40a.

1. On August 17, 2004, petitioners sued Harris in federal district court, alleging that Harris breached its fiduciary duty with respect to compensation under § 36(b). *See* JA1, 29-53. Petitioners requested damages under § 36(b), *see* 15 U.S.C. § 80a-35(b)(3), and rescission of the investment-advisory agreements between Harris and the funds, *see id.* § 80a-46(b) (providing that a contract that violates a provision of the ICA is subject to rescission). *See* JA34-35 (¶ 16), 52 (¶ 55), 53 (¶ 59, Prayer for Relief).

Harris moved to dismiss the complaint for failure to state a claim upon which relief could be granted. In denying that motion, the district court found petitioners' allegations that the fees Harris charged to the funds had increased significantly in recent years and that "other clients receive like services at significantly lower rates" sufficient to state a claim under § 36(b). JA26. The court also rejected Harris's contention that a § 36(b) claim cannot be based on an adviser's failure to share the benefits of economies

of scale generated as a fund's assets increase. *See* JA27 ("[I]f the money Harris is receiving can be fairly characterized as a fee and it is in essence something for nothing, clearly that would represent an actionably disproportional relationship between the fees paid and the services rendered."). Finally, the court rejected Harris's argument that petitioners' request for rescission should be stricken, explaining that the plain language of § 36(b), which refers to "damages *or other relief*," 15 U.S.C. § 80a-35(b)(3) (emphasis added), "refutes Harris's contention that the only remedy to be had is monetary." JA27.

After discovery, petitioners and Harris each moved for summary judgment. Harris argued that there was no genuine issue of material fact regarding its compliance with § 36(b), largely because its fees were in line with those paid by other captive mutual funds and had been approved by the funds' board of trustees. In opposing Harris's motion, petitioners presented evidence of multiple breaches of fiduciary duty by Harris.[5]

First, petitioners showed that Harris failed to deal fairly with the funds. Harris receives from the funds fees for investment-advisory services that are based on a percentage of each fund's net assets. In percentage terms, those fees are nearly twice as much as or more than what Harris charges its independent, non-fund clients for comparable services. *See* JA352-56 (¶¶ 19-23); *see also* Pet. App. 39a (Posner, J.); *id.* at 6a, 17a-18a. If Harris had applied the fee sched-

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[5] The Court views the facts in the light most favorable to petitioners, against whom summary judgment was granted below. *See, e.g., Pennsylvania State Police v. Suders*, 542 U.S. 129, 134 (2004); *Howlett v. Birkdale Shipping Co.*, 512 U.S. 92, 94 (1994).

ules used for comparable independent clients to the funds, the effective fee percentages for the funds would have been approximately half of what they were charged (less than half for the Oakmark Fund, far less than half for the Oakmark Equity & Income Fund, and just over half for the Oakmark Global Fund). *See* JA446-49; *see also* JA418. In dollar terms, the funds would have saved between $37 million and $58 million in one year alone under the fee schedules applicable to Harris's independent clients. *See* JA355-56 (¶ 23), 394-96.[6] Further, the disparity in the actual amounts paid by the two sets of clients is striking. For example, Harris charged the Oakmark Fund an effective rate of 0.88% on assets of $6.3 billion, and it charged an independent client with a comparable investment objective an effective rate of 0.45% on assets of $160 million. *See* JA447; *see also* JA171. Thus, the Oakmark Fund paid approximately $55 million in fees, while the independent client paid only $720,000 for essentially the same services.

Petitioners proffered evidence of additional unfair dealing by Harris. Documents and expert testimony showed that Harris was enjoying significant and increasing economies of scale, exacerbating the discrepancy between its fees and the cost of providing the services it rendered. *See* JA346-47 (¶¶ 11-12), 437-45, 452-60. From 2000 to 2003, assets in the Oakmark funds grew from approximately $5.7 billion to $26.7 billion, while personnel, occupancy, and

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[6] The relevant damages period is August 17, 2003, through the present. *See* 15 U.S.C. § 80a-35(b)(3) ("No award of damages shall be recoverable for any period prior to one year before the action was instituted."). The district court erroneously limited the damages period to the year preceding the filing of the complaint. *See infra* note 11.

operating costs decreased from 41% of total costs to only 15% of total costs. *See* JA346-47 (¶ 11), 453 (¶ 28). For the fiscal year ended September 30, 2003, Harris charged the funds more than $63 million in investment advisory fees, and for the fiscal year ended September 30, 2004, Harris charged the funds more than $109 million in investment advisory fees. *See* JA89, 104. Harris resisted instituting breakpoints (decreases in the fee percentage as assets exceed a certain amount). It indicated it would close one of the funds to new investors rather than implement breakpoints that would affect adversely its profits, even though its profit margins on advisory services exceeded 90% by some estimates (excluding profit-sharing payments from costs). *See* JA342-43 (¶ 6), 349-52 (¶¶ 15-18), 485-86; *see also* JA322-25 (¶¶ 10-11), 510-11, 517-20, 537, 539, 541.[7] Harris also improperly shifted distribution and research expenses from itself to the funds. *See* JA360-62 (¶¶ 28-30).

Second, petitioners presented evidence that Harris failed to provide the funds' board and shareholders with full and accurate disclosure of the material facts relating to its compensation. For example, Harris misinformed the board about the extent and cost of the services it provided to its other clients in comparison to the mutual funds. *See* JA356-57 (¶ 24).

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[7] The breakpoints added by Harris to the fee schedule did not reduce Harris's compensation for the upcoming year. *See* JA323-25 (¶ 11); *see also* JA88-89, 99-101. As of September 30, 2004, the Oakmark Global Fund still had not reached any of its breakpoints. *See* JA324 (¶ 11); *cf.* JA508-09 (testimony of fund trustee that "[w]e don't scientifically know exactly what we're doing when we put those breakpoints in" and that he did not "think [the board] would know" if the breakpoints were set too high).

And it provided the funds' trustees with inaccurate and incomplete information regarding its profitability and the extent to which it realized economies of scale. *See* JA339-46 (¶¶ 2-10), 347-48 (¶ 13), 381-88 (¶¶ 167-170, 175-177), 392-93, 399-415, 424-30. In addition, Harris failed fully to inform the board about its use of a Harris affiliate to double-charge the funds for commissions. *See* JA359-60 (¶ 27), 377-80 (¶¶ 30-36).

Third, petitioners contended that Harris breached its fiduciary duty under § 36(b) by accepting compensation in violation of the ICA's structural safeguards. For example, Victor Morgenstern, the chair of the funds' joint board and one of the designated disinterested trustees, was a former Harris partner who received deferred compensation from Harris worth hundreds of thousands of dollars per year. Yet, he participated in the statutorily mandated disinterested-trustee meetings at which Harris's fee agreements were reviewed and approved. *See* JA72 (¶ 13), 73-75 (¶¶ 21-23), 82 (¶ 48), 116-17, 363 (¶ 31); Pet. App. 2a-3a; 15 U.S.C. § 80a-15(c) (requiring a majority of disinterested directors to approve adviser compensation "at a meeting called for the purpose of voting on such approval"); *see also* JA110-11.[8] Further, the funds' registration statements did not disclose Morgenstern's financial interest in Harris, as the Act requires. *See* JA83 (¶ 51); Pet. App. 3a; 15 U.S.C. § 80a-33(b) (making it unlawful "to omit to state" in "any registration statement" or similar document "any fact necessary in order to prevent the statements made

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[8] A disinterested fund trustee testified that it was important for disinterested trustees to meet outside the presence of the interested trustees, who have "some ability to benefit from" the adviser's compensation. JA136.

therein, in the light of the circumstances under which they were made, from being materially misleading").[9] In addition, petitioners put forth evidence of numerous additional conflicting business and personal relationships among the trustees and Harris personnel, none of which was disclosed to the funds' shareholders, the investing public, or the SEC. *See, e.g.*, JA76 (¶ 28) (one designated disinterested trustee profited from a real estate transaction involving a Harris partner), 80 (¶¶ 42-44), 83 (¶ 52) (three designated disinterested trustees invested in hedge funds managed by a Harris corporate affiliate); *see also* Pet. App. 18a; JA75-80 (¶¶ 26-41), 81 (¶¶ 45-47), 364-68 (¶¶ 32-38).

2. The district court granted Harris's motion for summary judgment and dismissed the case. The court opined that "the only question we need consider is whether [the funds' board] could have agreed to the fee schedule in the advisory contracts after engaging in good-faith bargaining." Pet. App. 31a. The court answered that question in the affirmative, because the evidence "indicate[d] that the board as a whole was operating without any conflict that would [have] prevent[ed] it from engaging in arm's-length negotiations with Harris," *id.*, and because Harris's fees were comparable to those paid by other mutual funds, *id.* at 30a-32a. In the court's view, it did not matter whether Harris's independent clients paid far less for services that were "indistinguishable" from those the Oakmark funds received. *Id.* at 30a.[10]

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[9] Several of the funds' disinterested trustees were unaware of the specifics of Morgenstern's deferred compensation arrangement with Harris. *See* JA125-26, 132-33, 134.

[10] In rejecting petitioners' summary-judgment motion, the district court reasoned that an adviser's fiduciary duty under

3. a. The Seventh Circuit affirmed the district court's judgment. The court "disapprove[d]" the Second Circuit's "*Gartenberg* approach," Pet. App. 8a, under which an adviser violates § 36(b) when it charges a fee that exceeds "'the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances,'" *id.* at 5a (quoting *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982)). It instead held that an allegation that an adviser charged excessive fees for advisory services is not actionable under § 36(b). *See id.* at 8a. The court reasoned that "[a] fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Id.* So long as the adviser does not "pull[] the wool over the eyes" of the fund's directors, the board's approval of the adviser's compensation "is conclusive" and the adviser may "accept" whatever the board "agrees to pay." *Id.* at 8a-9a, 13a-14a.

The court allowed that it is "possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." *Id.* at 9a. But it held that such an inference could never be drawn where the adviser's compensation is "normal among similar institutions" – here, other mutual funds. *Id.* Accordingly, the court of appeals, like the district court, gave no weight to Harris having charged more to the funds than to its independent clients. *See id.* at 13a. (It also speculated, without reference to

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§ 36(b) does not include compliance with the structural provisions of the ICA on which petitioners relied. *See* Pet. App. 24a-26a. It also concluded that the statutory violations were essentially harmless because the board would have approved Harris's fees anyway. *See id.*

record evidence, that the Oakmark funds required more of Harris's time. *See id.*)

To support its interpretation of § 36(b), the court analogized investment-adviser fees to compensation of corporate managers and lawyers. It asserted that courts do not review what corporate boards or clients pay officers or attorneys and drew the conclusion that the "existence of the fiduciary duty does not imply judicial review for reasonableness." *Id.* at 10a. The court viewed its deregulatory approach as good policy, asserting that the large number of mutual funds reflects competition that invariably must constrain adviser compensation. *See id.* at 11a-13a.

The court briefly addressed petitioners' evidence that Harris violated its fiduciary duty with respect to compensation by failing to comply with the ICA's structural safeguards. It concluded that the financial relationship between Morgenstern (the supposedly disinterested trustee) and Harris would violate 15 U.S.C. § 80a-15(c) only if, taking away Morgenstern, the disinterested trustees who voted to approve Harris's compensation would not have made up a majority of all disinterested trustees. *See* Pet. App. 3a-4a. Similarly, the court concluded that the funds' shareholders could not recover for the failure to disclose Morgenstern's financial ties to Harris, unless Morgenstern's vote to approve Harris's fees was outcome-determinative. *See id.* at 3a.[11]

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[11] Petitioners appealed the district court's holding that the applicable damages period for this case is limited to the year preceding the filing of the complaint (Pet. App. 17a n.2) as inconsistent with 15 U.S.C. § 80a-35(b)(3). *See Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 825 (8th Cir. 2009). Because the Seventh Circuit did not reach that issue, it remains an open question on any remand from this Court.

b. The Seventh Circuit's active judges split five-to-five on whether to grant rehearing en banc, with one judge recused. Lacking a majority, the court of appeals denied rehearing. *See* Pet. App. 34a.

Judge Posner, joined by Judges Rovner, Wood, Williams, and Tinder, dissented from the denial of rehearing en banc. *See id.* at 35a-43a. Judge Posner explained that the court's "rejection" of the *Gartenberg* standard was based on "an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation." *Id.* at 37a (citing authorities). "Competition in product and capital markets can't be counted on to solve the problem," he wrote, "because the same structure of incentives operates on all large corporations and similar entities, including mutual funds." *Id.* at 38a; *see id.* at 40a-41a. After all, Judge Posner observed, "[m]utual funds are a component of the financial services industry, where abuses have been rampant." *Id.* at 38a.

Turning to this case, Judge Posner explained that "there is no doubt that the captive funds are indeed captive" and that the "Oakmark-Harris relationship matches the arrangement described in the Senate Report accompanying § 36(b): a fund 'organized by its investment adviser which provides it with almost all management services.'" *Id.* at 39a (quoting S. Rep. No. 91-184, at 5 (1969)); *see id.* at 40a. Judge Posner emphasized that a "particular concern" was Harris's practice of "charging its captive funds," in which petitioners invested, "more than twice what it charges independent funds." *Id.* at 39a. And he rejected as "airy speculation" the court's "suggestions on why this difference may be justified" – suggestions

he described as lacking "an evidentiary or empirical basis." *Id.* at 39a, 41a.

SUMMARY OF ARGUMENT

I. Under § 36(b), investment advisers such as Harris have "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). That fiduciary duty imposes two basic requirements with which an investment adviser must comply in obtaining its compensation. First, the adviser must fully and accurately disclose all material facts relating to its compensation. Second, the compensation must be fair to the fund, meaning that it comports with what would be bargained for in an arm's-length transaction. Those two mandates flow directly from the common-law meaning of the words "fiduciary duty," a meaning that Congress is presumed to have incorporated when it used those words in § 36(b).

That two-part fiduciary-duty standard fulfills Congress's purposes in enacting § 36(b). Congress enacted § 36(b) in response to the problem of excessive investment-adviser compensation. After considering investigations of scholars and the SEC and conducting its own hearings, Congress found that the forces of arm's-length bargaining were absent in the relationship between an investment adviser and a typical captive mutual fund. It further concluded that courts relied too heavily on approval by the boards of mutual funds in rejecting investors' challenges to adviser compensation. Accordingly, Congress added § 36(b) to provide an effective mechanism to ensure the fairness of adviser compensation, and it chose a familiar legal standard, imposing on investment advisers a fiduciary duty.

From the early 1980s until recently, the prevailing interpretation of § 36(b) was the standard set forth in the Second Circuit's decision in *Gartenberg*. That case correctly held that an investment adviser violates its fiduciary duty when it charges a fee that exceeds what could be obtained in an arm's-length transaction. Over the years, however, other courts have misunderstood certain aspects of the *Gartenberg* ruling, leading to decisions that depart from the proper interpretation of § 36(b). Under the correct standard, a § 36(b) violation can be established when an adviser charges its captive funds fees that are significantly higher for comparable services than those charged in arms-length transactions with independent clients.

II. The Seventh Circuit adopted a standard that finds no support in the statute's text or purposes. Under that standard, approval of the investment adviser's compensation by the fund's directors is "conclusive," unless the adviser "play[ed] . . . tricks" or "pulled the wool over" the directors' eyes. Pet. App. 8a-9a, 13a-14a. Although the court purported to look to the common law in fashioning its test, it misunderstood the pertinent common-law principles. Those principles establish that a fiduciary dealing with beneficiaries – as an investment adviser must do annually under the Act when seeking its compensation – must make full disclosure and ensure that the dealings are fair. Further, the Seventh Circuit's reliance on director approval conflicts with § 36(b)'s language and Congress's intent to supplant such reliance.

To support its interpretation of the statute, the Seventh Circuit sought to draw analogies to other sources of law and relied on policy arguments about

the state of competition in the mutual-fund industry, while disregarding § 36(b)'s plain text. In so doing, the court misunderstood the relevance of the other sources of law to which it looked and the ability of market forces to constrain investment-adviser compensation. Further, although the court suggested that the legislative history of § 36(b) supported its approach, in fact that history demonstrates that regulators and the industry agreed that § 36(b)'s fiduciary duty included a substantive check on adviser compensation.

Under a proper standard, petitioners' evidence warrants a trial on the merits. Petitioners have shown that Harris charges the funds approximately twice what it charges independent clients for comparable services. Such evidence alone suffices to establish a genuine issue of material fact for trial. In addition, petitioners have presented evidence that Harris failed to provide full and accurate disclosure of the material facts relating to its compensation and breached its obligation to deal fairly with the funds in multiple other respects.

ARGUMENT

I. SECTION 36(b) REQUIRES FULL DISCLOSURE AND FAIRNESS

A. Under An Established Canon Of Statutory Interpretation, § 36(b)'s Fiduciary Duty Incorporates Traditional Common-Law Requirements Of Full Disclosure And Fairness

Section 36(b) imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). In employing the phrase "fiduciary duty" in § 36(b), Congress incorporated the familiar common-law principles that phrase embodies. This Court repeatedly has applied the "well-established rule of construction that '[w]here Congress uses terms that have accumulated settled meaning under . . . the common law, a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms.'" *Neder v. United States*, 527 U.S. 1, 21 (1999) (quoting *Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322 (1992)) (alterations in original).[12] As this Court has recognized, the phrase "fiduciary duty" is exactly the type of well-known common-law term whose meaning Congress is presumed to have adopted. *See Varity Corp. v. Howe*, 516 U.S. 489, 502 (1996) (explaining that "the common law" has "given to terms such as 'fiduciary'" a "legal meaning to which, we normally presume, Congress meant to refer").

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[12] *Accord, e.g., NLRB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981); *see Evans v. United States*, 504 U.S. 255, 259 (1992) ("[A] statutory term is generally presumed to have its common-law meaning.") (internal quotation marks omitted).

Under the well-settled common law both before and after enactment of the 1970 amendments, a fiduciary has a strict duty of loyalty to act in the beneficiary's best interests. *See, e.g., Restatement (Second) of Trusts* § 2 cmt. b (1959) ("A person in a fiduciary relation to another is under a duty to act for the benefit of the other as to matters within the scope of the relation."); IIA Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 170, at 311 (4th ed. 1987) ("*Scott on Trusts*") ("The most fundamental duty owed by the trustee to the beneficiaries of the trust is the duty of loyalty. . . . It is the duty of a trustee to administer the trust solely in the interest of the beneficiaries.").[13]

When the fiduciary negotiates with a beneficiary regarding a transaction in which the fiduciary has an interest – for example, regarding the fiduciary's fee – the fiduciary must comply with two fundamental requirements. First, the fiduciary must provide full and accurate disclosure of all material facts relating to the transaction. Second, the transaction must be fair to the beneficiary. *See, e.g., Restatement (Second) of Trusts* § 2 cmt. b ("If the fiduciary enters into a transaction with the other and fails to make

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[13] *See also* George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 543, at 217 (rev. 2d ed. 1993) ("*Bogert's Trusts and Trustees*") ("Perhaps the most fundamental duty of a trustee is that he must display throughout the administration of the trust complete loyalty to the interests of the beneficiary and must exclude all selfish interest and all consideration of the interests of third persons."); *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, J.) ("Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.").

a full disclosure of all circumstances known to him affecting the transaction or if the transaction is unfair to the other, the transaction can be set aside by the other."); *Restatement (Third) of Trusts* § 2 cmt. b (2003) (same); *Restatement (Second) of Trusts* § 170(2) ("The trustee in dealing with the beneficiary on the trustee's own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know."); *Restatement (Third) of Trusts* § 78(3) (2007) (same); *Restatement (Second) of Trusts* § 170 cmt. w (trustee must ensure that beneficiary has "knowledge of his legal rights and of all material facts" and that "the transaction [is] fair"); *Restatement (Third) of Trusts* § 78 cmt. g ("in addition to complying with the requirement of full disclosure," the transaction "must be *fair* to the beneficiary and the trust," including "that the transaction is for a fair and adequate consideration").[14]

Those requirements of full disclosure and fairness apply specifically to a fiduciary's dealings regarding

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[14] *See also* IIA *Scott on Trusts* § 170.25, at 436 ("Where [the trustee] deals directly with the beneficiaries, the transaction may stand, but only if the trustee makes full disclosure and takes no advantage of his position and the transaction is in all respects fair and reasonable."); III *id.* § 216.3, at 347-48 (because the fiduciary and the beneficiary are in "a fiduciary relation" and "are not dealing at arm's length," the transaction can "be set aside if it is not a fair transaction"; it is "essential" that the transaction "be at a price that is fair and reasonable"); *Bogert's Trusts and Trustees* § 544, at 493, 496-97 (fiduciary owes a duty of "fair play in the direct dealing with his principal," which requires both "full and frank disclosure" and "consideration" that is "fair and adequate"); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) ("fair price" is a "basic aspect[]" of the "concept of fairness" in fiduciary law).

compensation. A trustee may seek to "enlarge[] or diminish[]" its compensation "by an agreement between [itself] and the beneficiary." *Restatement (Second) of Trusts* § 242 cmt. i. But such an agreement "will not bind the beneficiary" if either "the trustee failed to make a full disclosure of all circumstances affecting the agreement" or "the agreement is unfair to the beneficiary." *Id.* (citing *Restatement (Second) of Trusts* § 170); *accord Restatement (Third) of Trusts* § 38 cmt. f. Indeed, the rule that a trustee can negotiate with the beneficiary regarding its compensation so long as it provides full disclosure and deals fairly is an exception to the general rule that fiduciaries are "strictly prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests." *Restatement (Third) of Trusts* § 78(2). That strict prohibition against self-dealing "do[es] not apply to the trustee's taking of *reasonable* compensation for services rendered as trustee." *Id.* cmt. c(4) (emphasis added). No comparable exception exists, however, for *unreasonable* compensation. A fiduciary taking *un*reasonable compensation simply engages in prohibited self-dealing.[15]

This Court's decisions recognize those fiduciary principles. In *Pepper v. Litton*, 308 U.S. 295 (1939),

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[15] The Court cites the *Restatements of Trusts*, *Scott on Trusts*, and *Bogert's Trusts and Trustees* as reliable authorities on the common law. *See, e.g., Kennedy v. Plan Adm'r for DuPont Sav. & Inv. Plan*, 129 S. Ct. 865, 872 (2009); *Harris Trust & Sav. Bank v. Salomon Smith Barney Inc.*, 530 U.S. 238, 250, 252 (2000); *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101, 111-12 (1989); *see also Field v. Mans*, 516 U.S. 59, 70 n.9 (1995) (the Court construes statutes "to incorporate the general common law" and "the dominant consensus of common-law jurisdictions, rather than the law of any particular State").

for example, the Court explained that a fiduciary's dealings with its beneficiary "are subjected to rigorous scrutiny." *Id.* at 306. The fiduciary must act in "good faith," and the transaction must be "fair[] from the viewpoint of the" beneficiary. *Id.* "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." *Id.* at 306-07; *see Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921) ("[W]here the fairness of [transactions between a corporate fiduciary and the corporation] is challenged the burden is upon those who would maintain them to show their entire fairness and where a sale is involved the full adequacy of the consideration.").[16] And "[c]ourts have imposed on a fiduciary an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading his clients." *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (internal quotation marks and footnotes omitted).[17]

In the aftermath of the 1970 amendments, the Second Circuit construed § 36(b) in light of those

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[16] In congressional hearings leading to § 36(b)'s enactment, *Pepper* and *Geddes* were quoted with approval in discussing the fiduciary-duty standard. *See* 1969 Hearings 190 (SEC Memorandum), 199-200 (testimony of Hon. Hamer H. Budge, SEC Chairman).

[17] Notwithstanding statements that a fiduciary bears the burden of proving the fairness of a transaction with the beneficiary, *see, e.g., Geddes*, 254 U.S. at 599, § 36(b) provides that "the plaintiff shall have the burden of proving a breach of fiduciary duty," 15 U.S.C. § 80a-35(b)(1). Here, petitioners adduced ample evidence that Harris breached its fiduciary duty, including evidence that it charges the funds twice as much as it charges independent clients for comparable services.

same common-law principles. The court explained that "Congress, in imposing a fiduciary obligation on investment advisers, plainly intended that their conduct be governed by the traditional rule of undivided loyalty implicit in the fiduciary bond." *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 811 (2d Cir. 1976).[18] The Second Circuit held that, as a fiduciary, the investment adviser must fully disclose to the fund (its beneficiary) information regarding the adviser's compensation: "It is axiomatic, therefore, that a self-dealing fiduciary owes a duty of full disclosure to the beneficiary of his trust." *Id.* The court further explained that, "even where a fiduciary has made full disclosure, it is the duty of a federal court to subject the transaction to rigorous scrutiny for fairness." *Id.* at 811-12 (citing *Pepper*, 308 U.S. at 306-07). In an appeal decided after this Court granted certiorari in this case, the Eighth Circuit articulated a similar, two-part fiduciary standard in interpreting § 36(b). *See Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 823-24 (8th Cir. 2009).

B. Interpreting § 36(b) To Incorporate Traditional Common-Law Principles Serves Congress's Purposes

Congress enacted § 36(b) to protect investors from excessive adviser compensation. It fulfilled that purpose by using language that incorporated traditional principles of fiduciary-duty law designed to protect the beneficiary in its dealings with the fiduciary. The 1970 amendments grew out of a lengthy delib-

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[18] This Court has quoted *Galfand* with approval in recognizing that "the '"relationship between investment advisers and mutual funds is fraught with potential conflicts of interest."'" *Daily Income Fund*, 464 U.S. at 536 (quoting *Burks*, 441 U.S. at 481, quoting in turn *Galfand*, 545 F.2d at 808).

erative process involving analysis of the mutual-fund industry and a focus on replicating the results of true arm's-length bargaining.

1. Spurred by the thorough investigations of the mutual-fund industry conducted by the Wharton School and the SEC, congressional committees held hearings over a multi-year period and considered multiple versions of proposed legislation. *See supra* pp. 4-6 (describing background); S. Rep. 91-184, at 1-4 (same); H.R. Rep. No. 91-1382, at 2-3 (1970) (same). From that extensive record, Congress found that "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy," because "a mutual fund cannot, as a practical matter[,] sever its relationship with the adviser." S. Rep. 91-184, at 5; *accord* H.R. Rep. 91-1382, at 7; *Burks*, 441 U.S. at 481. In particular, "problems [had] arise[n] due to the economies of scale attributable to the dramatic growth of the mutual fund industry" – economies that advisers had not always "shared with investors." S. Rep. 91-184, at 6. Section 36(b) was intended in part to ensure that investors would "share equitably . . . in the economies available as a result of the growth and general acceptance of mutual funds." *Id.* at 4; *see also id.* at 3 (recognizing that mutual funds "and those who entrust their savings to such [funds] stand in special need of legal protection").

Those perceived market failures led Congress to re-examine the legal standards for protecting mutual-fund investors. Although the 1940 Act had placed some structural requirements on the industry, it "did not provide any mechanism by which the fairness of management contracts could be tested in court." *Id.* at 5. Under the 1940 Act, courts required investors

challenging investment-adviser fees to prove a "gross abuse of trust." And the existing state-law standard of corporate waste could be satisfied only if the adviser's fees were "unconscionable." *See Daily Income Fund*, 464 U.S. at 540 & n.12; *supra* p. 6. That standard drew substantial criticism for being "unduly restrictive" as applied to the mutual-fund industry. S. Rep. 91-184, at 5; *see* H.R. Rep. 91-1382, at 7; *Daily Income Fund*, 464 U.S. at 534 n.10, 537, 540-41 & n.12.

Section 36(b) was enacted to impose on investment advisers "a specific 'fiduciary duty' in respect to management fee compensation" and to "provide a mechanism for court enforcement of this duty." S. Rep. 91-184, at 5-6. Put differently, § 36(b) "authorize[s] the court to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee." *Id.* at 6. Under § 36(b), "the ultimate test" – "even if the compensation or payments [have been] approved by the directors and stockholders" – is not whether the compensation "involves a 'waste' of corporate assets," but "whether the investment adviser has fulfilled his fiduciary duty to the mutual fund shareholders in determining the fee." *Id.* at 15-16; *accord* H.R. Rep. 91-1382, at 38.[19] The Senate report explained that § 36(b) was "in accordance with the traditional function of the courts to enforce such fiduciary duties in similar type relationships." S. Rep. 91-184, at 6; *see*

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[19] *See also* H.R. Rep. 91-1382, at 87 (SEC Memorandum) ("It would be anomalous indeed for Congress to declare that the investment adviser has a fiduciary duty with respect to his fee and then to turn around and say that he can breach that duty with impunity, no matter how outrageous the breach, if directors and shareholders who have no other choice, approve the contract. This is contrary to the basic law of fiduciary duty.").

id. at 7 (stating that § 36(b) "is designed" "to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation").

2. This Court's cases have recognized that Congress intended § 36(b) to serve those purposes and that Congress sought to permit claims under § 36(b) even when the fund's disinterested directors have approved the adviser's compensation. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991) ("Congress added § 36(b) to the ICA in 1970 because it concluded that the shareholders should not have to 'rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board.'") (quoting *Daily Income Fund*, 464 U.S. at 540)). The *Daily Income Fund* Court explained that "Congress intended security holder and SEC actions under § 36(b), on the one hand, and directorial approval of adviser contracts, on the other, to act as independent checks on excessive fees." 464 U.S. at 541. That conclusion arose, in part, from the SEC's contention that § 36(b) "reflects a congressional determination that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors." Brief for the SEC as Amicus Curiae in Support of Affirmance at 9, *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984) (No. 82-1200).

Thus, this Court's cases and the legislative history recognize Congress's understanding that arm's-length bargaining was absent from the usual captive mutual-fund structure and that investment advisers were obtaining economies of scale that should be shared with fund shareholders. The history further

demonstrates that Congress's purpose in enacting § 36(b) was to replace the unduly restrictive corporate waste standard for challenging adviser fees with a more effective standard anchored in familiar principles of fiduciary-duty law.

C. *Gartenberg* Correctly Articulates The Fairness Requirement Of The Fiduciary-Duty Standard, But Subsequent Cases Have Distorted It

In *Gartenberg*, the Second Circuit expounded on the second prong of the fiduciary standard – the requirement of fairness. The court held that "the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances." 694 F.2d at 928. The *Gartenberg* court's reference to approximating the results of true arm's-length bargaining comports with the fairness requirement recognized in the common-law authorities discussed above.

Gartenberg also correctly held that one of the least probative "factor[s] to be considered in evaluating a fee's fairness is the price charged by other similar advisers to funds managed by them." *Id.* at 929. "Reliance on prevailing industry advisory fees will not satisfy § 36(b)," the court explained, because "the existence in most cases of an unseverable relationship between the adviser-manager and the fund it services tends to weaken the weight to be given to rates charged by advisers of other similar funds." *Id.* (citing SEC Report 131, 148); *see id.* ("Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers

for fund business."); *see also* Pet. App. 38a, 40a-41a (Posner, J.); *Gallus*, 561 F.3d at 824.

Other aspects of the *Gartenberg* decision, however, are in tension with traditional common-law principles or have been applied by subsequent courts in at least three ways inconsistent with those principles.

First, courts have misread *Gartenberg* in holding that a comparison between the fees an adviser charges to its captive mutual funds and those it charges to independent clients is irrelevant as a matter of law in a § 36(b) suit.[20] *Gartenberg* "rejected" a comparison between the fees charged to the money-market fund at issue there and the fees charged "to large pension funds." 694 F.2d at 930 n.3. But that money-market fund operated "like a bank account" in that "[i]dle money [could] be invested in the Fund for as little as a day and put to work earning interest." *Id.* at 925. The large pension funds being compared did not "face the myriad of daily purchases and redemptions throughout the nation which must be handled by" the money-market fund. *Id.* at 930 n.3. The Second Circuit thus rejected that comparison based on the particular characteristics of the entities before it. The court did not suggest that a comparison of fees charged for like services provided to different clients (*e.g.*, a mutual fund and an institutional client with the same investment objective) would be irrelevant.[21]

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[20] *See, e.g., Strougo v. BEA Assocs.*, 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002).

[21] *See Gallus*, 561 F.3d at 824. The money-market fund in *Gartenberg* was unusual in that the brokerage function was integrated into the advisory function, *see Gartenberg*, 694 F.2d at 926, making inapt a comparison to advisory services provided to other accounts that did not include the brokerage service.

In fact, such a comparison is highly probative in assessing whether the result of a transaction between an adviser and a fund is fair to the fund. It enables the court to determine whether the price charged by the adviser-fiduciary to the fund is comparable to an arm's-length transaction. Judge Posner recognized the evidentiary value of such a comparison when he criticized the court below for ignoring the "comparison of the fees that Harris charges independent funds with the much higher fees that it charges the funds it controls." Pet. App. 41a; *see id.* at 39a ("A particular concern in this case is the adviser's charging its captive funds more than twice what it charges independent funds."); *see also Gallus*, 561 F.3d at 824 ("The purpose of an inquiry into the fees paid by institutional, non-fiduciary clients is to determine what the investment advice is worth."). Thus, evidence of fees charged to an adviser's independent clients for comparable services is highly pertinent in a § 36(b) case.

Second, although the *Gartenberg* court correctly identified the "test" as whether the fee is comparable to an "arm's-length" deal, it added the erroneous additional concept that, "[t]o be guilty of a violation of § 36(b)," the adviser "must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." 694 F.2d at 928; *cf.* Pet. App. 5a (describing these as "two variations on a theme"). That formulation – in particular, the "so disproportionately large" language – is inconsistent with the proper comparison to arm's-length transactions and traditional fiduciary principles, and subsequent courts have been led astray by it.

In addition, although the *Gartenberg* court correctly recognized that "all of the surrounding circumstances" are relevant in determining whether the fee is comparable to an arm's-length bargain, 694 F.2d at 928,[22] subsequent courts have erroneously translated the facts in *Gartenberg* into a rigid checklist of factors on which plaintiffs must produce evidence in a § 36(b) case. *See, e.g., Krinsk v. Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409 (2d Cir. 1989) (listing six factors). Evidence on many of those issues is within the adviser's exclusive control and, even with full discovery, can generate complicated factual disputes.[23] Analysis of those factors thus creates needless confusion when more probative proof is available.

An example of that error arises when courts assess whether the adviser received so-called "fall-out benefits" – additional revenue from providing other services to investors in the fund. *See id.* at 411. If investors can show that an adviser charged its captive fund significantly higher fees than in an arm's-length transaction, it should not matter whether they can prove that the adviser also received fall-out benefits but took no account of them in determining the fee

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[22] *See* S. Rep. 91-184, at 15 (courts should "look at all the facts in connection with the determination and receipt of such compensation . . . to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation"); H.R. Rep. 91-1382, at 37 (same).

[23] Moreover, undue focus on factors such as "the profitability of the fund to the adviser-manager," *Krinsk*, 875 F.2d at 409, threatens to transform § 36(b) into the type of cost-based rate-making statute that Congress sought to avoid. *See* S. Rep. 91-184, at 6.

it charged to the fund.[24] When combined with the refusal to recognize the relevance of fees charged to independent clients, such an analysis strays far from the fiduciary principles that properly govern § 36(b) claims.

Third, some courts have read *Gartenberg* to mean that the *only* type of claim cognizable under § 36(b) is one alleging that the adviser charged "excessive" fees.[25] The claim at issue in *Gartenberg* focused on excessive fees, but the Second Circuit did not purport to hold that § 36(b)'s "fiduciary duty" excludes the traditional requirement of full disclosure. Indeed, neither *Gartenberg* itself nor any subsequent Second Circuit case casts doubt on *Galfand*, in which the Second Circuit recognized the adviser's disclosure obligation. *See Gallus*, 561 F.3d at 823-24 & n.3.

In sum, *Gartenberg*'s core holding – that an adviser breaches its fiduciary duty under § 36(b) when it charges a fee that exceeds what could be obtained in an arm's-length transaction – correctly interprets § 36(b) in accordance with traditional fiduciary principles. Some of the gloss that subsequent courts have placed on *Gartenberg* is, however, unmoored from the common-law foundations of § 36(b)'s fiduciary duty and thus should be rejected.

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[24] If an adviser received fall-out benefits but those benefits were ignored in setting the adviser's fee, that would be relevant in determining the adviser's compliance with its fiduciary duty.

[25] *See Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 328 (4th Cir. 2001) ("Section 36(b) is sharply focused on the question of whether the fees themselves were excessive"); *see also Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 118 (2d Cir. 2007) (per curiam) (under § 36(b), plaintiff "must allege excessive fees, rather than fees that might simply be described as 'improper'") (citing *Gartenberg*, 694 F.2d at 928).

II. THE SEVENTH CIRCUIT'S RADICAL REVISION OF § 36(b) CONFLICTS WITH THE STATUTE'S TEXT AND PURPOSES

Under the Seventh Circuit's approach, approval of the investment adviser's compensation by the fund's directors is "conclusive," unless the adviser "play[ed] . . . tricks" or "pulled the wool over" the directors' eyes. Pet. App. 8a-9a, 13a-14a. That standard enables an adviser to take as much as it can get. The court's dramatic departure from the prevailing interpretation of § 36(b) finds no support in the statute's text or purposes. Instead, it is premised primarily on analogies to other sources of law and policy arguments about the competitive state of the mutual-fund industry. Such arguments provide no basis for deviating from the statute's plain text. In any event, the court misunderstood the relevance of the other sources of law to which it looked and the ability of market forces to constrain investment-adviser compensation. Under a proper standard, petitioners' evidence warrants a trial on the merits.

A. The Seventh Circuit Misunderstood The Applicable Common-Law Principles

The court of appeals properly looked to the common law in interpreting § 36(b). *See* Pet. App. 8a (noting that "fiduciary" is "a familiar word; to use it is to summon up the law of trusts"). But the court misunderstood the pertinent common-law principles. In particular, it erroneously analogized the approval of adviser compensation to arm's-length bargaining that precedes the creation of a trust. And it unduly limited the adviser's duty of disclosure.

1. The analogy to arm's-length bargaining over the creation of a trust is inapt

The Seventh Circuit suggested that, under trust law, an investment adviser should be able to "negotiate in his own interest and accept what" the fund's board agrees to pay. Pet. App. 8a. The authorities it cited (*see id.* at 8a-9a) address a quite different situation, however. They address the standard applicable when the document creating the trust establishes a trustee's compensation. Such compensation can be the product of an agreement between the settlor (the person who creates the trust) and the trustee. A potential settlor and a prospective trustee can, before the creation of the trust, engage in arm's-length bargaining over the fee that the potential trustee would receive if it agreed to accept the duties and responsibilities of a trustee. When such arm's-length negotiation occurs between unrelated parties, some cases have enforced that bargain, even if the trustee's compensation appears high compared to what trustees typically receive for similar work. *See Restatement (Second) of Trusts* § 242 cmt. f; *cf.* John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 Yale L.J. 625 (1995) (arguing that a trust instrument generally may vary most fiduciary duties imposed by trust law).[26]

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[26] Professor Langbein acknowledges that, even where the trust instrument is the product of arm's-length bargaining, the instrument does not control in all circumstances. *See* Langbein, 105 Yale L.J. at 651 & n.134 ("If the settlor directs an objectively stupid investment policy, the court will direct deviation even though the settlor anticipates the circumstance."); *see also Restatement (Third) of Trusts* § 38 cmt. e ("[i]f the amount of compensation provided by the terms of the trust is or becomes unreasonably high or unreasonably low, the court may allow a smaller or larger compensation"). Professor Langbein also

But that rule has no application for the typical captive mutual fund, where the adviser creates the fund and engages in no ex ante bargaining over its compensation. The adviser is in a fiduciary relationship to the fund from the outset. The analogy to arm's-length bargaining between a settlor and a potential trustee is therefore inapt, because the potential trustee ordinarily owes no fiduciary duty to a settlor when negotiating the terms of the trust.[27]

Further, the agreement between the adviser and the fund setting the adviser's compensation is renewed annually. *See* 15 U.S.C. § 80a-15(a)(2). Section 36(b) requires the adviser to behave as a fiduciary during that process. The adviser must provide full disclosure of all material facts – an obligation not imposed on parties negotiating at arm's length – and, even when full disclosure has been made, the transaction must be fair to the fund. *See supra* pp. 21-25. The common law recognizes that negotiations between the trustee and the beneficiary regarding the trustee's compensation trigger those obligations. *See Restatement (Second) of Trusts* § 242 cmt. i (an agreement with the beneficiary regarding the trustee's compensation "will not bind the beneficiary . . . if the

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admits that his analysis, based on the primacy of contract, deviates from traditional understandings of trust law. *See, e.g.*, Langbein, 105 Yale L.J. at 644-45 (noting that the traditional "doctrinal account of the trust remains inimical to recognizing the contractarian basis of the trust" and that "present-day doctrine embrace[s] an anticontractarian account").

[27] In the unusual case where a fiduciary relationship does exist between the settlor and the potential trustee, the potential trustee has a duty to ensure that the trust instrument does not provide for unreasonable compensation. *See Restatement (Second) of Trusts* § 242 cmt. f; *Lederman v. Lisinsky*, 112 N.Y.S.2d 203, 205-06 (Sup. Ct. 1952).

trustee failed to make a full disclosure of all circumstances affecting the agreement which he knew or should have known or if the agreement is unfair to the beneficiary") (citing *Restatement (Second) of Trusts* § 170, the provision governing transactions between trustee and beneficiary).

2. *The court misstated the adviser's duty of disclosure*

The Seventh Circuit stated that § 36(b) requires only that the investment adviser refrain from "play[ing] . . . tricks" or "pull[ing] the wool over" the trustees' eyes. Pet. App. 8a, 13a-14a. That depiction misstates the common-law requirement that § 36(b) incorporates. A fiduciary's duty of disclosure mandates more than the avoidance of "tricks" and other fraudulent behavior. It requires the adviser to communicate "*all material facts* in connection with the transaction." *Restatement (Second) of Trusts* § 170(2) (emphasis added).[28]

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[28] *See, e.g., Fogel v. Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975) (Friendly, J.) ("an investment adviser is 'under a duty of full disclosure'" in "'every area where there was even a possible conflict of interest between [its] interests and the interests of the fund'"; "'[t]he only question can be whether the matter is one that could be thought to be of possible significance'"; and "the communication of information must be 'effective,' bearing in mind that the independent directors are not full-time employees") (quoting *Moses v. Burgin*, 445 F.2d 369, 376-77 (1st Cir. 1971)); *Wendt v. Fischer*, 243 N.Y. 439, 444 (1926) (Cardozo, J.) ("[T]he disclosure to be effective must lay bare the truth, without ambiguity or reservation, in all its stark significance.") (citations omitted); *Restatement (Second) of Agency* § 390 cmt. a (1958) (agent must "disclose to the principal all relevant facts fully and completely" before dealing with the principal, and a "fact is relevant if it is one which the agent should realize would be likely to affect the judgment of the principal in giving his consent").

B. The Court Below Erroneously Treated Board Approval As "Conclusive"

The Seventh Circuit also indicated that, absent evidence that the adviser "pulled the wool over" the trustees' eyes, the fund board's decision to approve the adviser's compensation ordinarily should be treated as "conclusive" under § 36(b). Pet. App. 9a, 13a-14a. That conclusion cannot be squared with § 36(b)'s language and purposes or the common-law principles it incorporates.

Giving conclusive weight to board approval contradicts the express statutory mandate that director approval should be afforded only "such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). Indeed, as this Court has recognized, Congress intended to ensure that director approval *not* be given conclusive weight in litigation challenging the adviser's fee. *See supra* pp. 26-28. Further, the common law recognizes that the beneficiary's consent to a transaction with the fiduciary – which is analogous to director approval – is not conclusive where the beneficiary was not aware of "the material facts" or the transaction "involved a bargain which was not fair and reasonable." *Restatement (Second) of Trusts* § 216(2)(b), (3); *see also id.* cmt. n; III *Scott on Trusts* § 216.3, at 347-48 ("[I]t is not enough that the beneficiary had full knowledge of all the facts and of his legal rights, and that his consent was not improperly induced by the trustee. It is essential also that the [transaction] should be at a price that is fair and reasonable.").

The statute's structure reinforces that conclusion. The ICA requires annual board approval of the adviser's compensation. *See* 15 U.S.C. § 80a-15(a)(2). The 1970 amendments added a requirement that the

adviser provide to the board "such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company." *Id.* § 80a-15(c). The Seventh Circuit's conclusion that § 36(b)'s fiduciary duty requires only that the adviser obtain the fund board's approval of the fee after some level of disclosure renders § 36(b) superfluous in light of § 15(c).

Moreover, the facts here illustrate Congress's wisdom in not giving director approval conclusive effect. During much of the relevant period, the chairman of the funds' board of trustees (Victor Morgenstern), who was supposedly a disinterested trustee, was a former partner of Harris with a continuing financial interest in Harris worth hundreds of thousands of dollars per year. *See supra* p. 12.[29] The funds' trustees and Harris personnel also shared numerous conflicting business and personal relationships. *See* JA75-81 (¶¶ 26-47), 364-68 (¶¶ 32-38). As Judge Posner explained, when, as here, "'directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely.'" Pet. App. 40a (quoting Camelia M.

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[29] Although designated as a disinterested trustee, Morgenstern in fact met the ICA's definition of an "interested person" of an investment adviser, which includes "any person who knowingly has any direct or indirect beneficial interest in . . . *any security* issued either by such investment adviser . . . or by a controlling person of such investment adviser." 15 U.S.C. § 80a-2(a)(19)(B)(iii) (emphasis added). The Act broadly defines a "security" as "any note, . . . evidence of indebtedness, . . . or participation in any profit-sharing agreement." *Id.* § 80a-2(a)(36). That definition encompasses Morgenstern's deferred compensation, which is contingent on Harris's revenues. *See* JA73-75 (¶¶ 21-23), 119-22, 128-30 (describing Morgenstern's interest).

Kuhnen, *Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry* (Mar. 1, 2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=849705); *see id.* at 38a-39a.

C. The Lower Court's Analogies To Other Sources Of Law Do Not Support The Standard It Adopted

The Seventh Circuit sought to bolster its interpretation of § 36(b) by drawing analogies to other sources of law. But those analogies are unpersuasive.

The court first compared investment-adviser fees to corporate executives' compensation. *See* Pet. App. 9a-10a. Because Congress enacted § 36(b) in response to the inadequacy of existing state corporate-law standards governing excessive-compensation claims – standards that often required a showing of "corporate waste," *Daily Income Fund*, 464 U.S. at 540 n.12 – reliance on those same standards to *narrow* the statute's scope would subvert Congress's purpose. Indeed, Congress's greater concern over the compensation of investment advisers compared to corporate officers' reflects its recognition of the prevailing market forces. As courts and scholars have recognized, conflicts of interest "occur[] much more frequently in the relations between a mutual fund and its investment adviser than in ordinary business corporations." *Fogel v. Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975) (Friendly, J.); *see* Donald C. Langevoort, *Private Litigation To Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 Wash. U. L.Q. 1017, 1032 (2005) ("[t]hinking about mutual funds . . . as a species of 'corporations' . . . is completely misguided").

The Seventh Circuit's analogy to lawyer compensation, *see* Pet. App. 10a, is likewise misplaced. "A

lawyer may not charge a fee larger than is reasonable in the circumstances." *Restatement (Third) of Law Governing Lawyers* § 34 (2000). And special rules apply where a fee agreement is reached "after the lawyer began to serve." *Id.* cmt. c. That standard is the appropriate analogy here because the adviser creates the fund and renews its compensation agreement annually. Fee agreements between lawyer and client reached during the representation "are subject to special scrutiny" and must be "fair and reasonable to the client under the circumstances in which [they were] entered." *Id.* § 18 cmt. e. Further, in determining the reasonableness of a lawyer's fee, courts consider fees agreed to in arm's-length bargains struck at the outset of the representation. *See id.* § 34 cmt. c (courts ask whether "the contract provide[s] for a fee within the range commonly charged by other lawyers in similar representations"); *see also Blum v. Stenson*, 465 U.S. 886, 895 (1984) (holding that "'reasonable fees' under [42 U.S.C.] § 1988 are to be calculated according to the prevailing market rates in the relevant community"). Here, the appropriate point of comparison is arm's-length transactions between investment advisers and unaffiliated clients, not compensation agreements reached during an adviser's relationship with its captive fund.

D. The Seventh Circuit Ignored Congressional Intent

1. The court below also believed that Congress's intentions in enacting § 36(b) were irrelevant: what Congress thought "about the structure of the mutual-fund market" in 1970 should be ignored because "[t]oday thousands of mutual funds compete." Pet. App. 11a. In the court's view, competition among

mutual funds for shareholders constrains adviser fees. *See id.* at 7a, 11a-13a. The Seventh Circuit's reasoning is flawed.

First, courts are not permitted to substitute their own economic analysis for Congress's. If competition in the mutual-fund industry truly has progressed such that § 36(b)'s fiduciary-duty standard does more harm than good, the appropriate remedy is through congressional amendment, not judicial fiat. *See TVA v. Hill*, 437 U.S. 153, 185 (1978) ("It is not for us to speculate, much less act, on whether Congress would have altered its stance had the specific events of this case been anticipated."); *see also General Motors Corp. v. Tracy*, 519 U.S. 278, 308 (1997) ("[T]he Court is institutionally unsuited to gather the facts upon which economic predictions can be made, and professionally untrained to make them.").

Second, the Seventh Circuit's reasoning rests on what Judge Posner described as "an economic analysis that is ripe for reexamination." Pet. App. 37a. As a practical matter, several considerations restrict investors' ability to switch mutual funds in response to high fees. If an individual has owned a particular fund for a sufficient length of time, selling her shares likely would trigger adverse tax consequences. Such considerations might not apply to investors in tax-advantaged plans such as 401(k) accounts. Even so, 401(k) plans and similar investment vehicles often have a limited menu of investment choices that restrict the investor's options to high-priced funds.[30]

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[30] *See* Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans, 73 Fed. Reg. 43,014, 43,020 & n.13 (proposed July 23, 2008) (to be codified at 29 C.F.R. pt. 2550) ("A review of the relevant literature suggests that [401(k)]

Third, behavioral economists have demonstrated that most mutual-fund investors do not rationally process fee information, so that the market does not punish high-priced funds in the way the Seventh Circuit speculated it should.[31] Studies show that mutual funds are sold primarily based on past performance, rather than costs, even though costs dramatically affect investors' returns over time.[32]

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plan participants on average pay fees that are higher than necessary by 11.3 basis points per year.") (citing sources).

[31] *See, e.g.*, James J. Choi, David Laibson & Brigitte C. Madrian, *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds* 5 (Mar. 26, 2009) (forthcoming in *The Review of Financial Studies*) (finding that MBA students and undergraduates in elite educational institutions failed to minimize fees when selecting among S&P 500 index funds), http://www.som.yale.edu/faculty/jjc83/fees.pdf; Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows*, 78 J. Bus. 2095, 2098 (2005) (demonstrating that "there is at best no relation, and at worst a perverse positive relation, between fund flows and operating expenses"); *see also* Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 Colum. Bus. L. Rev. 934, 989 (discussing empirical research showing that "many investors still do not make expenses a major factor in their fund choices"); Langevoort, 83 Wash. U. L.Q. at 1033, 1035-36.

[32] *See* U.S. General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* 72 (June 2000) ("[W]hen evaluating funds, investors generally gave greater consideration to several other factors before considering fund fees. The primary factor investors used in selecting mutual funds was generally the fund's performance."), http://www.gao.gov/archive/2000/gg00126.pdf; U.S. Securities and Exchange Comm'n, Division of Investment Management, *Report on Mutual Fund Fees and Expenses* 3-4 (Dec. 2000) (recognizing that mutual fund expenses are "important because they can have a dramatic impact on an investor's return" – "[f]or example, a 1% increase in a fund's annual expenses can reduce an investor's

Finally, the lower court's economic analysis ignored that brokers distribute most funds.[33] Advisers entice brokers and other intermediaries – through outright payments and indirect compensation – to place investors in their funds.[34] Those payments to brokers, which are often financed by fees charged to fund shareholders (known as "12b-1" fees),[35] significantly affect investors' mutual-fund choices.[36]

2. In declining to follow congressional intent, the Seventh Circuit also suggested that Congress had considered and rejected "language that would have authorized review of rates for reasonableness." Pet. App. 10a-11a. It is true that Congress considered, but did not enact, bills explicitly requiring adviser fees to be "reasonable." But that is beside the point. The pertinent legislative history confirms that Congress intended to incorporate the common-law mean-

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ending account balance in that fund by 18% after twenty years"), http://www.sec.gov/news/studies/feestudy.htm.

[33] One study found that, in 2004, 64% of funds were distributed primarily through brokers. *See* Daniel Bergstresser, John Chalmers & Peter Tufano, *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* 6-7 (Sept. 26, 2007) (forthcoming in *The Review of Financial Studies*), http://www.people.hbs.edu/dbergstresser/dbjchpt.pdf.

[34] *See, e.g.*, Laura Johannes & John Hechinger, *Conflicting Interests: Why a Brokerage Giant Pushes Some Mediocre Mutual Funds*, Wall St. J., Jan. 9, 2004, at A1.

[35] 12b-1 fees are paid out of fund assets to market the fund to potential investors. *See* William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence* 21-22, 2010 U. Ill. L. Rev. (forthcoming) (discussing 17 C.F.R. § 270.12b-1), http://ssrn.com/abstract=1412878.

[36] *See* Bergstresser at 18 ("sales effort, measured by compensation to brokers through front loads and 12b-1 fees, is positively associated with" investments in funds).

ing of fiduciary duty, which requires full disclosure and substantive fairness in fee agreements.

In its 1966 report that led to the 1970 ICA amendments, the SEC proposed amending the Act to require that all adviser compensation be "reasonable." *See* SEC Report 144. Proposed amendments to ICA § 15 – the provision requiring adviser compensation to be set forth in contracts approved by the fund's board – would have required all adviser compensation to be "reasonable."[37] The investment-company industry opposed the SEC's proposal, and it was not enacted.[38]

In April 1969, one Senator suggested during hearings that the SEC and industry representatives consider whether they could submit a joint proposal based on a fiduciary-duty standard.[39] That suggestion led to extensive negotiations between the SEC and industry representatives, culminating in the submission to Congress of a compromise position, which imposed a fiduciary duty on investment advisers in lieu of the reasonableness requirement that

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[37] *See, e.g.*, H.R. 9510, 90th Cong. § 8(d) (1967).

[38] *See Mutual Fund Legislation of 1967: Hearings Before the S. Comm. on Banking and Currency*, 90th Cong. 298-99 (1967) (statement of Joseph Welch on behalf of the Investment Company Institute ("ICI")) (expressing concern about the "vagueness" and "uncertainty of judicial interpretation" of the reasonableness standard); S. Rep. 91-184, at 5 (noting Senate passage of a bill containing reasonableness requirement but that the House took no action on it).

[39] *See* 115 Cong. Rec. 13,646, 13,648 (1969) (statement of Sen. McIntyre); 1969 Hearings 185 (testimony of Hon. Hamer H. Budge, SEC Chairman); *Investment Company Amendments Act of 1969: Hearings Before the S. Comm. on Banking and Currency*, 91st Cong. 193-94 (1969).

initially had been proposed.[40] As both the SEC and industry representatives explained, the fiduciary-duty provision differed from the proposed reasonableness standard in two respects. First, the fiduciary-duty standard placed the focus on the investment *adviser* to fulfill its duty to the fund and the fund's shareholders; the industry had expressed concern that the reasonableness standard would make fund *directors* a target of litigation challenging adviser fees.[41] Second, proponents thought the switch from reasonableness to fiduciary duty would avoid concerns that the legislation was authorizing cost-based rate regulation of the type imposed on public utilities.[42]

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[40] *See* 1969 Hearings 138 (SEC Memorandum), 184-85 (testimony of Hon. Hamer H. Budge, SEC Chairman; Phillip A. Loomis, Jr., SEC General Counsel; and Solomon Freedman, Director of the SEC Division of Corporate Regulation).

[41] *See* 1969 Hearings 188-89 (SEC Memorandum) ("The reasonableness standard was not agreeable to the ICI, although they did not object to the proposition that management fees should be reasonable, because the ICI argued that the earlier standard would focus any court action which might arise on the conduct of the fund directors. The ICI wanted to shift the focus of any litigation in the fee area to the investment adviser. To accomplish this the reasonableness standard was replaced by the standard in H.R. 11995 which specifies that the investment adviser has a fiduciary duty with respect to management fee compensation."); *id.* at 441 (Letter from Robert L. Augenblick, President and General Counsel of the ICI) (fiduciary-duty provision "differs from the 'reasonableness' approach first in a procedural way" – a suit may be brought "only against the adviser or other person who received the compensation").

[42] *See* 1969 Hearings 441 (ICI Letter) (fiduciary-duty standard "not intended to imply that the investment adviser is not entitled to make a profit or to suggest that any type of 'cost plus' contract would be required"); *see also id.* at 189 (SEC Memorandum) ("Investment advisers, like other corporate fiduciaries, such as banks, are entitled to make a profit[.]").

Significantly, both the SEC and industry representatives told Congress that they expected courts to apply traditional fiduciary-duty principles in interpreting the new provision, and both recognized that those principles required not only full disclosure but also substantive fairness. During a committee hearing on a bill containing the fiduciary-duty standard, members of Congress asked the SEC and industry representatives to submit their views on the fiduciary-duty standard and how, if at all, it differed from prior bills containing a reasonableness test.[43] In response, the SEC explained that "a breach of fiduciary duty involving management fees would occur when compensation to the adviser for his services is excessive in view of the services rendered – where the fund pays what is an unfair fee under the circumstances."[44] The President and General Counsel of the Investment Company Institute similarly wrote that a fiduciary "may not overreach in the amount of his fee even though the other party to the transaction, in full possession of all the facts, does not believe the fee is excessive."[45]

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[43] *See* 1969 Hearings 187, 440.

[44] 1969 Hearings 190 (SEC Memorandum); *see also, e.g., id.* at 188 ("[t]he Commission views [the fiduciary-duty standard] as a significant and meaningful improvement over the existing law and at least as helpful as the reasonableness standard [in a prior bill]"); *id.* at 190 n.4 (quoting with approval an Illinois Supreme Court decision stating, in the context of defining "fairness," that courts consider "'whether there was full disclosure – *although neither disclosure nor shareholder assent can convert a dishonest transaction into a fair one*'") (quoting *Shlensky v. South Parkway Bldg. Corp.*, 166 N.E.2d 793, 802 (Ill. 1960)) (emphasis added in 1969 Hearings).

[45] 1969 Hearings 441 (ICI Letter); *see also id.* (stating ICI's belief that "the court will look to the general law of fiduciary

Thus, Congress considered but rejected a provision that some feared would have licensed the SEC and the courts to impose a cost-based rate structure on the mutual-fund industry. It instead enacted a statute that, all agreed, directed courts to apply familiar fiduciary-duty principles to investment advisers' compensation.

E. Under A Proper Standard, Petitioners' Evidence Warrants A Trial On The Merits

Petitioners' evidence was more than sufficient to raise genuine issues of material fact for trial.[46]

1. Harris undisputedly charged the Oakmark funds nearly twice as much as or more than it charged independent clients. *See supra* pp. 9-10. The lower court "thr[ew] out some suggestions" (Pet. App. 39a (Posner, J.)) to justify that disparity, saying that "[d]ifferent clients call for different commitments of time" and "[m]utual funds may grow or shrink quickly," allegedly "complicat[ing] an adviser's task," *id.* at 13a. But, as Judge Posner explained, such "airy speculation," lacking "an evidentiary or empirical basis," cannot justify summary judgment for Harris. *Id.* at 39a, 41a.

In fact, the record refutes the speculation that differences in services justify the vastly higher fees

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relationships" and that "[t]he court would undoubtedly consider" both "whether the investment adviser has acted fairly and diligently in supplying information to the Board of Directors of the investment company" and "the substance and quality of the negotiations which led to the contract").

[46] The remanded proceedings would be a bench trial. Courts have held that there is no right to a jury trial in cases under § 36(b), *see, e.g., Kalish v. Franklin Advisers, Inc.*, 928 F.2d 590, 591-92 (2d Cir. 1991) (per curiam), and neither party has requested a jury trial.

charged to the funds. The evidence showed that Harris furnished substantively identical services to its institutional and fund clients. *See* JA353-54 (¶¶ 20-21), 416-17, 449, 475-76.[47] Indeed, expert testimony demonstrated that it in fact costs Harris *more* to serve its institutional clients. *See* JA354-55 (¶ 22), 431-34, 493-96.

An oft-cited journal article claims that many services provided to mutual funds are not furnished to institutional accounts. *See* John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 185 (2007) ("Coates & Hubbard"). That article was funded in part by the mutual-fund industry and co-authored by an expert witness for investment advisers in § 36(b) cases, and therefore its objectivity is unreliable.[48] Regardless, the record in this case refutes the article's supposition that all funds receive additional administrative services in exchange for a higher advisory fee. The evidence shows that the funds pay separate fees for adminis-

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[47] *See also* JA505-06 (testimony of Harris's director of research that managers of the mutual funds and the independent accounts share equally all work done by the research department), 512 (testimony of Harris fund manager that, when he buys a stock, he buys it for all mutual funds and independent accounts with the same investment objective); 513-14 (testimony of Harris fund manager that "all of our analysts do research for all of our clients"), 318 (testimony of Harris fund manager that the funds maintain sufficient cash to handle redemptions without having to liquidate securities positions).

[48] *See* Coates & Hubbard 151 n.aa1; *see also* Asher Hawkins, *Well-Funded Opinion*, Forbes (May 8, 2009), http://www.forbes.com/2009/05/07/mutual-funds-fidelity-columbia-business-school-personal-finance-hubbard.html; *cf. Exxon Shipping Co. v. Baker*, 128 S. Ct. 2605, 2626 n.17 (2008) ("declin[ing] to rely on" research "funded in part by" party to the case).

trative services pursuant to separate agreements. *See* JA352-53 (¶ 19).[49] The advisory fees here are for pure portfolio-management services, *see id.*, which allows for the apples-to-apples comparison the article advocates, *see* Coates & Hubbard 186.[50] Moreover, even accepting at face value Harris's assertions that it provides additional services to the funds (and ignoring the evidence that the services provided to the institutional clients are more costly), the cost of those additional services is negligible compared to the difference in fees. *See* JA354-55 (¶ 22), 432-33.

In addition, the court below was simply wrong to rely on comparisons between fees paid by the Oakmark funds and other mutual funds. *See* Pet. App. 9a, 30a. Comparing fees paid by two captive mutual funds, neither of which bargains at arm's length with

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[49] JA543-47, 551-55 (transfer agency and service agreement), 556-57 (custodian agreement), 558-60 (administration agreement); *see also* JA531 (investment advisory agreement for Oakmark Fund providing that "the Adviser may receive compensation from the Trust for other services performed by or for the Trust which are not within the scope of the duties of the Adviser under this agreement").

[50] The district court's offhand statement that Harris provided "more limited" services to its independent clients than to the funds (Pet. App. 16a) provided no basis on which to justify summary judgment against petitioners in light of the conflicting evidence. *See, e.g., Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986) ("'[A]ll that is required'" to raise a genuine issue of fact precluding summary judgment "'is that sufficient evidence supporting the claimed factual dispute be shown to require a jury or judge to resolve the parties' differing versions of the truth at trial.'") (quoting *First Nat'l Bank of Arizona v. Cities Serv. Co.*, 391 U.S. 253, 288-89 (1986)). Indeed, the district court also recognized that "the evidence [plaintiffs] have adduced establishes at most that others paid different amounts for *similar services*." Pet. App. 32a (emphasis added).

its adviser, says very little about whether the fees are fair and comparable to what would be charged in an arm's-length transaction. *See Gartenberg*, 694 F.2d at 929; *supra* pp. 29-30. Moreover, giving dispositive weight to that comparison in every case "would be to eviscerate § 36(b)." *Gallus*, 561 F.3d at 823; *see also* Pet. App. 38a, 40a-41a (Posner, J.).

The district court also placed great weight on the funds' performance, focusing solely on the three-year period ending in 2004. *See* Pet. App. 32a. But it ignored that, for the three-year period ending August 31, 2006, which includes most of the damages period, the funds' performance declined significantly. Indeed, the Oakmark Fund was one of the poorest performers in its class over that period, earning a Morningstar Rating of only one star. *See* JA335.[51] Regardless, § 36(b) imposes a fiduciary duty with respect to "compensation," not performance. Focusing on the latter would make poorly performing funds especially vulnerable to suit, a result benefiting neither investment advisers nor investors.

When, as here, there is evidence that an adviser charges its captive funds substantially higher fees than it charges independent clients for comparable services, that disparity between the compensation paid by the captive fund and the compensation negotiated through actual arm's-length bargaining suffices to create a genuine issue of material fact as to whether the adviser has breached its fiduciary duty with respect to compensation.

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[51] The district court refused to consider post-2004 performance because it had concluded, erroneously, that the damages period ended when the complaint was filed. *See supra* note 11.

2. In addition, petitioners adduced substantial other evidence of Harris's breaches of fiduciary duty under § 36(b), *see supra* pp. 9-13, including:

- failing accurately and fully to disclose information about its profitability and economies of scale, *see* JA339-49 (¶¶ 2-14);
- resisting breakpoints on fees, *see* JA349-52 (¶¶ 15-18);
- providing inaccurate and incomplete information about the extent and cost of the services provided to its other clients compared to the mutual funds, *see* JA356-58 (¶¶ 24-25);
- failing to inform the board about the use of a Harris affiliate to double-charge the funds for commissions, *see* JA359-60 (¶ 27);
- causing the funds to pay increased distribution payments to intermediaries who sold shares of the funds, *see* JA360-62 (¶¶ 28-29);
- failing to disclose that one supposedly disinterested trustee earned more than $1.6 million in profits from a real estate transaction involving a Harris partner, *see* JA76 (¶ 28); and
- failing to disclose that three supposedly disinterested trustees were heavily invested in hedge funds managed by a corporate affiliate of Harris, *see* JA80 (¶¶ 42-44), 83 (¶ 50).

Petitioners also demonstrated that Harris violated the ICA's structural protections in multiple ways. *See supra* pp. 12-13, 39 & n.29. They showed that Harris had secured approval of its fees from a group of supposedly disinterested trustees that in fact included a former Harris partner (Morgenstern) who had a continuing financial interest in Harris worth hundreds of thousands of dollars per year, in

violation of § 15(c) of the ICA, 15 U.S.C. § 80a-15(c). Petitioners also demonstrated that Harris had failed to report to the SEC and the investing public its continuing financial relationship with the board's supposedly disinterested chair, in violation of § 34(b) of the ICA, 15 U.S.C. § 80a-33(b).[52]

By failing to discuss that evidence in analyzing petitioners' § 36(b) claim, the Seventh Circuit implicitly deemed it irrelevant (or at least insufficient to raise a triable issue of fact) under the standard the court adopted. For this reason, the lower court's holding is doubly pernicious. It erroneously required shareholders to prove that the adviser "pulled the wool over the eyes of the disinterested trustees" who approved the adviser's compensation, Pet. App. 13a-14a, and then it ignored substantial evidence that Harris engaged in the types of "tricks" that the court suggested would sustain a § 36(b) claim, *id.* at 8a. By upholding summary judgment for respondent, the Seventh Circuit articulated and applied a standard that renders § 36(b) a dead letter.

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[52] The Court need not decide whether a violation of ICA § 15(c) or § 34(b) alone establishes a breach of fiduciary duty under § 36(b) (an issue the court below did not directly address, although it was properly presented). At a minimum, evidence of violations of those provisions is relevant to whether an adviser has breached its fiduciary duty under § 36(b). *See Krinsk*, 875 F.2d at 409 (explaining that trustees' independence is a factor in applying the *Gartenberg* standard); *Gartenberg*, 694 F.2d at 929 (under § 36(b), "all pertinent facts must be weighed"); S. Rep. 91-184, at 15 (courts should "look at all the facts in connection with the determination and receipt of such compensation," including "whether the deliberations of the directors were a matter of substance or a mere formality"); H.R. Rep. 91-1382, at 37 (same).

CONCLUSION

The judgment of the court of appeals should be reversed.

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June 10, 2009

RESPONDENT'S BRIEF

138 (17)

No. 08-586

Supreme Court, U.S.
FILED
AUG 27 2009
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

**On Writ of Certiorari
to the United States Court of Appeals
for the Seventh Circuit**

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QUESTION PRESENTED

Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. §80a-35(b), states that investment advisers have a "fiduciary duty with respect to the receipt of compensation" from mutual funds, and creates a private cause of action for shareholders to enforce that obligation. For nearly 30 years, the mutual fund industry and the SEC have agreed upon the understanding of that text set forth in the Second Circuit's decision in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982): To breach its "fiduciary duty with respect to the receipt of compensation," the "adviser-manager must charge a fee that is *so disproportionately large* that it bears no reasonable relationship to the services rendered and *could not have been the product of arm's-length bargaining.*" *Id.* at 928 (emphasis added). In this case, the district court granted summary judgment on undisputed facts that expenses were similar to (or even below) competitors' charges despite best-in-class performance, and were the result of a robust and fully informed negotiation between the adviser and the funds' disinterested trustees. The Seventh Circuit affirmed.

The question presented is whether the "fiduciary duty with respect to the receipt of compensation" imposed by §36(b) requires a shareholder to prove that a mutual fund adviser's fee was so disproportionately large that it could not have been the product of arm's-length bargaining.

CORPORATE DISCLOSURE STATEMENT

Pursuant to Supreme Court Rule 29.6, Respondent Harris Associates L.P. ("Harris") states that it is a Delaware limited partnership managed by its general partner, Harris Associates, Inc., which owns 0.33% of the limited partnership interests. Harris Associates, Inc. is a wholly-owned indirect subsidiary of Natixis Global Asset Management, L.P. ("Natixis U.S."). Natixis U.S. owns 99.67% of Harris's limited partnership interests and, through its wholly-owned subsidiary, Natixis Global Asset Management Holdings, LLC, all of the outstanding shares of Harris Associates, Inc. No publicly held corporation owns 10% or more of Harris's stock.

Natixis U.S. is part of Natixis Global Asset Management, an international asset management group based in Paris, France, that is ultimately owned principally, directly or indirectly, by three affiliated French financial services firms: Natixis, an investment banking and financial services firm; the Caisse Nationale des Caisses d'Epargne, a financial institution owned by French regional savings banks known as the Caisses d'Epargne; and the Banque Federale des Banques Populaires, a financial institution owned by regional cooperative banks known as the Banques Populaires. Natixis is a public company whose shares trade on the Euronext Paris exchange.

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IN THE

Supreme Court of the United States

NO. 08-586

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

On Writ of Certiorari
to the United States Court of Appeals
for the Seventh Circuit

BRIEF FOR RESPONDENT

STATEMENT

In 1970, Congress amended the Investment Company Act of 1940 ("ICA"), 15 U.S.C. §80a-1 *et seq.*, to reinforce the statute's protections for investors with respect to the fees that mutual funds pay to their investment advisers. See Investment Company Amendments Act of 1970 (the "1970 Amendments"), Pub. L. No. 91-547, 84 Stat. 1413. Recognizing the "cornerstone" role of independent mutual fund boards, the 1970 Amendments "strengthened" the ICA's requirement of director independence, *Burks* v. *Lasker*, 441 U.S. 471, 482 (1979); required investment

advisers to provide mutual fund boards with exhaustive information material to fee negotiations; and vested in the independent directors the exclusive authority to approve a fee contract. 15 U.S.C. §§80a-2(a)(19), 80a-10(a), 80a-15(c).

Congress coupled those enhancements with a new enforcement mechanism. Congress added §36(b) to the ICA to provide that investment advisers have a "fiduciary duty with respect to the receipt of compensation" and created a private cause of action for breach of that duty. 15 U.S.C. §80a-35(b). In selecting the "fiduciary duty" formulation, Congress navigated between earlier proposals requiring that fees be "reasonable," and state-law rulings that limited fee review to concepts of "waste." Congress rejected a "reasonable" fee standard because it would authorize a court to "substitute its business judgment" for the actions of the board of directors. See S. Rep. No. 184, 91st Cong., 1st Sess. 6 (1969). State law "waste" standards, on the other hand, deferred to board decisions with little regard for the quality of board deliberations. *Id.* at 5. Congress chose the "fiduciary duty" standard as a compromise between the two extremes, and ordered that courts reviewing claims for breach of the obligation "shall" give "approval by the [mutual fund's] board of directors * * * such consideration as is deemed appropriate under all the circumstances." 15 U.S.C. §80a-35(b)(2).

This case concerns the standard for determining whether a "breach of fiduciary duty with respect to the receipt of compensation" has occurred.

I. Statutory And Industry Background

A. Statutory Background

A mutual fund is an investment company that pools money from multiple investors for investment in stocks,

bonds, or other securities. Mutual funds offer an attractive and popular investment vehicle for many individuals. They allow disparate and dispersed investors to obtain the benefits of professional management of their investment dollars and diversification across multiple investments and asset classes. There are mutual funds available for every asset class, investment style, and industrial and geographical sector. Mutual funds afford investors substantial liquidity, allowing them to redeem shares for reinvestment elsewhere with ease.

1. The management of mutual funds is typically externalized. Most mutual funds "are formed, sold, and managed" by a "separately owned and operated" investment adviser that "select[s] the funds' investments and operates their business." *Burks*, 441 U.S. at 481 (quoting S. Rep. No. 184, *supra*, at 5); see *Daily Income Fund* v. *Fox*, 464 U.S. 523, 536 (1984). Contractually delegating management to an external adviser, however, poses the risk of conflicts between the fund and its manager. *Burks*, 441 U.S. at 481. Accordingly, the ICA requires mutual funds to be independent from, and disinterested with respect to, their investment advisers in multiple ways. *Id.* at 482; 15 U.S.C. §§ 80a-10(a) to 10(b), 80a-15(a) to 15(c). That requirement is the "cornerstone of the ICA's effort to control conflicts of interest within mutual funds." *Burks*, 441 U.S. at 482. At least 40 percent of a mutual fund's directors or trustees must be "disinterested" with respect to the investment adviser. 15 U.S.C. § 80a-10(a). The ICA "assigns a host of special responsibilities" to those "statutorily disinterested" board members. *Burks*, 441 U.S. at 482-83. Critically, they must "review and approve the contracts of the investment adviser" annually. *Id.* at 483. And the fees paid to the in-

vestment adviser may be established only by a majority of disinterested trustees. 15 U.S.C. §80a-15(c).

Section 15(c) of the ICA requires investment advisers to furnish, and independent directors to examine, all information "reasonably * * * necessary to evaluate the terms" of any investment advisory contract. 15 U.S.C. §80a-15(c). That includes extensive disclosures relating to the adviser's fees, costs, and profits. SEC rules require funds to disclose to shareholders the weight boards attribute to (a) the costs of services the investment adviser provides, (b) the profits the investment adviser realizes, (c) the extent of economies of scale as the fund grows, and (d) how such economies benefit investors. See 69 Fed. Reg. 39,798, 39,808 (June 30, 2004). Independent board members are thus in a position to act as "independent watchdogs." *Burks*, 441 U.S. at 484 (quoting *Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir. 1977)).

2. Motivated by the "substantial growth of the investment company industry since 1940," see H.R. Rep. No. 2337, 89th Cong., 2d Sess. vii (1966), Congress amended the ICA in 1970 to "strengthen further the independence" of fund boards, *Burks*, 441 U.S. at 483. The 1970 Amendments imposed "stricter requirement[s]" limiting director "interests," *id.* at 482-83; see 15 U.S.C. §80a-2(a)(19), and added provisions "designed to assist directors in discharging their responsibilities," S. Rep. No. 184, *supra*, at 6, including the requirement that advisers disclose to independent directors all information "reasonably * * * necessary to evaluate the terms" of any investment advisory contract, 15 U.S.C. §80a-15(c).

At the same time, Congress established a new mechanism to authorize federal legal challenges to management fees. Although Congress specifically declined to find that

advisory fees were generally excessive,[1] Congress added §36(b) to the ICA, which provides that investment advisers have "a fiduciary duty with respect to the receipt of compensation" from a mutual fund. 15 U.S.C. §80a-35(b). The measure created a private cause of action for shareholders to assert on behalf of a fund "for breach of fiduciary duty in respect of such compensation or payments" to the investment adviser. *Ibid.*

3. Congress formulated the "fiduciary duty with respect to the receipt of compensation" as a compromise between state-law "waste" standards and a previously proposed standard of "reasonableness." The "corporate waste" standard that some courts had applied to claims of excessive adviser compensation had been heavily criticized. S. Rep. No. 184, *supra*, at 5; see, *e.g.*, *Saxe* v. *Brady*, 40 Del. Ch. 474, 486 (1962). Under that standard, board approval of fees was often dispositive, with little regard to the quality of the board's deliberations. Courts would upset a fee only if it was "unconscionable" or "shocking." *Daily Income Fund*, 464 U.S. at 534 n.10, 540 n.12. Congress deemed such "waste" standards "unduly restrictive." S. Rep. No. 184, *supra*, at 5.

Congress also rejected proposals that advisory fees be "reasonable." It "delet[ed]" the "requirement of 'reasonableness'" from versions of a bill the Senate passed in a prior session, and "substitute[d]" the fiduciary-duty standard as "a different method of testing management compensation." S. Rep. No. 184, *supra*, at 5. Congress noted that under the "fiduciary duty" standard, a court

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[1] See S. Rep. No. 184, *supra*, at 5 (provisions "should not be taken as reflecting any finding by the committee that the present industry level of management fees or that the fee of any particular adviser is too high"); *id.* at 6 ("provision does not represent a finding by the committee as to the level of fees in the industry").

would not "substitute its business judgment for that of the mutual fund's board of directors in the area of management fees." See *ibid.*

Congress's path between the extremes also found expression in a provision giving courts discretion to determine how much weight to give to the board's approval of a fee. Under §36(b)(2), courts "shall" accord board approval "such consideration * * * as is deemed appropriate under all the circumstances." 15 U.S.C. §80a-35(b)(2). Congress proposed that courts ask "whether the deliberations of the directors were a matter of substance or a mere formality." H.R. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970). A "responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored." S. Rep. No. 184, *supra*, at 6.

4. Congress's adoption of a "fiduciary duty" standard created a "unique right," *Daily Income Fund*, 464 U.S. at 524, that was drawn from familiar principles. But Congress modified those principles to adapt them to the context of mutual funds. A fiduciary ordinarily bears the burden to justify its transactions under applicable substantive rules. See *Pepper* v. *Litton*, 308 U.S. 295, 306 (1939) (citing *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921)). In §36(b), Congress reversed that burden, imposing "the burden of proving a breach of fiduciary duty" on the plaintiff. 15 U.S.C. §80a-35(b)(1). Congress also limited recovery under §36(b) to "actual damages" arising from the breach, and excluded recovery "for any period prior to one year before the action was instituted." *Id.* §80a-35(b)(3).

B. Developments In The Mutual Fund Industry

Since the 1970 Amendments were enacted, the mutual fund industry has experienced exponential growth. As-

sets under management increased from $38.2 billion, H.R. Rep. No. 2337, *supra*, at vii, to over $9.6 trillion in 2008, ICI Fact Book 20 (May 2009), http://www.icifactbook.org/pdf/2009_factbook.pdf. The number of mutual fund investors increased more than 20-fold from 3.5 million in 1965 to 92 million in 2008. *Id.* at 73. Some 700 financial services companies compete for investors' dollars by sponsoring fund "families" that offer an array of funds across multiple asset classes and investment objectives. *Id.* at 13. Those companies afford choices among almost 8,900 open-end mutual funds, approximately 650 closed-end funds, and over 700 Exchange Traded Funds. *Id.* at 15. Bank deregulation and the migration from defined benefit to defined contribution retirement plans have helped fuel this growth. *Id.* at 77. Low barriers to industry entry—and the absence of barriers to investment exit—have also driven this expansion. John C. Coates, IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 167-70 (2007).

In that dynamic environment, competition among fund complexes is fierce. While advisers rarely compete for the business of funds formed by competitors, sponsors of fund complexes compete aggressively for investors' dollars on the basis of factors such as fees, performance, and service. Coates & Hubbard, *supra*, at 153, 196. As a result, the average expenses for stock funds declined from 2.32% of assets in 1980 to 0.99% in 2008. ICI Fact Book, *supra*, at 60-61; see also Coates & Hubbard, *supra*, at 173-77.

SEC regulations compel exhaustive disclosure about fund performance, fees, and comparative information. See *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*,

69 Fed. Reg. 39,798, 39,807-09 (2004). Self-regulatory organizations and private enterprises have erected an enormous informational edifice to complement the mandatory disclosure regime, including services such as Morningstar.com. See, *e.g.*, *Calculating Mutual Fund Fees and Expenses*, http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm; FINRA Fund Analyzer, http://apps.finra.org/fundanalyzer/1/fa.aspx. Investors affirmatively respond to these resources. Between 1999 and 2008, funds with below-mean expense ratios obtained dramatically increased investment inflows and funds with above-mean expenses suffered net outflows. ICI Fact Book, *supra*, at 63. As the Seventh Circuit summarized, "investors can and do 'fire' advisers cheaply and easily by moving their money elsewhere" when fees "are excessive in relation to the results." Pet. App. 11a-12a.

II. Proceedings In This Case

Respondent Harris Associates L.P. ("Harris") is an investment adviser. Petitioners own shares in three funds that Harris manages in the Oakmark "family" of mutual funds: the Oakmark Fund, the Oakmark Equity and Income Fund, and the Oakmark Global Fund (the "Funds"). J.A. 138-39. On August 17, 2004, petitioners commenced this action on behalf of those Funds, alleging that during the one-year period before the Complaint was filed, Harris breached its fiduciary duty with respect to the receipt of compensation under § 36(b) by charging "excessive" fees. J.A. 52; Pet. App. 29a. The same lawyers simultaneously filed nearly identical complaints against a dozen separate complexes.[2]

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[2] See *Hunt* v. *Invesco Funds Group*, No. 04-cv-2555 (S.D. Tex); *Baker* v. *Am. Century Inv. Mgmt.*, No. 04-cv-4039 (W.D. Mo.); *Gallus* v. *Am. Express Fin. Corp.*, No. 04-cv-4498 (D. Minn.); *Bauer* v. *Federated Equity Mgmt. Co.*, No. 04-cv-702 (W.D. Pa.); *Bennett* v.

A. Performance, Fees, And Fee Negotiations

During the one-year period preceding the Complaint, the Funds outperformed their respective market benchmarks and virtually every fund in their peer universe. For that best-in-class performance, petitioners paid aggregate fees and expenses similar to—or below—those paid by comparable funds.

1. *Harris's Performance Record*

Harris and the Funds' independent board renegotiated contracts every year. The Funds' independent trustees engaged industry consultant Lipper, Inc. to assist in their effort. J.A. 144-45.

Global Fund. For the three- and four-year periods ending on March 31, 2004, the Oakmark Global Fund had the single best net returns of the 200-plus comparable funds in its Lipper-defined "performance universe"; for each time period, it exceeded the benchmark index by over 20 percentage points. J.A. 147, 280. The average annual return for the three-year period ending on March 31, 2004 was 22.36% net of fees, better than *any* of the funds Lipper considered comparable. That annualized return was nearly 10 times its Lipper benchmark. *Ibid.* The Global Fund's average annual net return over the preceding four-year period was 20.24%—again the single best performance result of any comparable fund; by contrast, the Lipper benchmark had an average annual *loss*. *Ibid.*

Fidelity Mgmt. & Research Co., No. 04-cv-11651 (D. Mass.); *Strigliabotti* v. *Franklin Res., Inc.*, No. 04-cv-883 (N.D. Cal.); *Sins* v. *Janus Capital Mgmt. LLC*, No. 04-cv-1647 (D. Colo.); *Dumond* v. *Mass. Fin. Servs. Co.*, No. 04-cv-11458 (D. Mass.); *Krueger* v. *Neuberger Berman Mgmt., Inc.*, No. 05-cv-1316 (S.D.N.Y.); *Vaughn* v. *Putnam Inv. Mgmt.*, No. 04-10988 (D. Mass.); *Williams* v. *Waddell & Reed Inv. Mgmt. Co.*, No. 04-cv-2561 (D. Kan.).

Equity and Income Fund. For the three-year period ending on March 31, 2004, the Equity and Income Fund returned on average 12.49% net of fees, the third best performance of 445 peer funds and over three times its Lipper benchmark. J.A. 146, 272. For the five-year period ending on March 31, 2004, the Equity and Income Fund's average annual net return of 13.91% was the best in its peer universe, and far above the benchmark return of 3.11%. *Ibid.* The Equity and Income Fund's performance exceeded its Lipper benchmark by almost 9 percentage points in the three-year period and by over 10 percentage points in the five-year period. *Ibid.*

Oakmark Fund. For the three-year period ending on March 31, 2004, the Oakmark Fund generated an average annual return of 6.22% net of fees, about four times its Lipper benchmark. J.A. 147, 297. Lipper ranked the fund 12th out of the 307 funds Lipper considered comparable. *Ibid.* For the five-year period ending on March 31, 2004, the Oakmark Fund's average annual net return was 5.29%, more than four times the benchmark's 1.22%, and the fund ranked 18th out of 224 comparable funds. *Ibid.*

Harris's performance garnered widespread accolades. See J.A. 147-49. *Money* magazine awarded Oakmark funds "top marks" for having "especially laudable or innovative policies" in its survey of "fund companies [that] put investors first." *Id.* at 148. Morningstar selected the Oakmark Fund's portfolio manager as the industry's "Domestic Stock Manager of the Year" for 2001. *Ibid.* *SmartMoney* magazine named him one of the 11 top fund managers out of 11,000 under consideration. *Id.* at 149. *Barron's* similarly named the managers of Oakmark Equity and Income Fund and Oakmark Global Fund as the top managers in their respective categories. *Ibid.*

2. *The Fees*

Despite best-in-class performance, Fund shareholders paid management fees and expenses that were unremarkable. Management fees for the Funds were at or slightly above medians for comparable funds. See J.A. 271-86, 291-98. Aggregate expenses compared favorably to peers. The Global Fund's aggregate expenses were 0.168% below the median for its peer group. Total expenses for the Equity and Income Fund and the Oakmark Fund exceeded their respective peer medians by 0.025% and 0.174%. J.A. 145.

Harris supplied the trustees with materials on a wide variety of topics related to those fees. The materials described the multiple services Harris provides to the Funds; the Harris personnel providing those services; the investment performance of the Funds; and the profitability of the contracts to Harris. Harris gave the trustees detailed information about Harris's expenses; transactions between the Funds and Harris's affiliates (*e.g.*, its broker-dealer); "soft-dollar" and similar benefits to Harris; and compliance information about best execution of portfolio transactions, the allocation of transactions among broker-dealers, and compliance with the Funds' investment restrictions. J.A. 143-44, 152-81.

Harris also provided the Funds' trustees with extensive data about its activities as an investment adviser to a variety of non-mutual fund clients, including the accounts of institutional investors and high net-worth individuals, as well as its provision of "sub-advisory" services to various mutual funds for which other investment advisers acted as the primary adviser. J.A. 146. The Funds' trustees requested and Harris provided a description of the fees Harris charged to those non-mutual fund clients as well as a comparison of the more extensive services Har-

ris provided to the Funds with those provided to other clients. J.A. 146, 152-81.

3. *The Fee Negotiations*

The negotiations culminating in each fee contract were robust. J.A. 141-45. They spanned several months and multiple meetings between Harris and the trustees. *Id.* at 141-43. Much of the trustees' information gathering and analysis was completed by the board's Management Contracts Committee, which made a recommendation to the full board for consideration. *Id.* at 143. The Management Contracts Committee met on multiple occasions over each contract negotiation cycle. *Ibid.* The trustees were advised throughout by independent, outside legal counsel. *Id.* at 143-44.

The trustees negotiated increasingly favorable terms. Mutual fund fee agreements often provide "breakpoints"—asset levels at which an asset-based fee declines. In the years preceding the filing of the Complaint, the Funds' trustees negotiated the initiation of additional breakpoints for the Funds. J.A. 140-41. Rather than "resisting" such breakpoints, as petitioners contend, Pet. Br. 11, the trustees negotiated two new breakpoints for the Oakmark Fund, four new breakpoints for the Equity and Income Fund, and two new breakpoints for the Global Fund during the 2003 and 2004 fee negotiation processes. J.A. 140-41.

B. Proceedings In District Court

Petitioners' Complaint alleged that Harris's fees were "disproportionate to the services rendered" and "not within the range of what would have been negotiated at arm's length in light of all the surrounding circumstances." J.A. 52. The pleading explicitly declared that the Second Circuit's decision in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir.

1982) ("*Gartenberg*"), set forth the "test for determining whether compensation paid to Defendant violates §36(b)." J.A. 36.

After extensive discovery, both parties moved for summary judgment. Harris relied upon the *Gartenberg* standard that petitioners' Complaint invoked: It argued that, on the undisputed record, the fees it charged were not so disproportionate that they could not have been the product of arm's-length bargaining. See Mem. of Law in Supp. of Def. Harris Associates L.P.'s Mot. for Summ. J. at 14-26. The petitioners' opposition abandoned *Gartenberg*, asserting they "do *not* agree that *Gartenberg* sets forth the appropriate test for determining whether a violation of §36(b) has occurred." Mem. of Law in Supp. of Pls.' Opp. to Def. Harris Assocs. L.P.'s Mot. for Summ. J. at 6 n.4 (emphasis added).

The district court adopted *Gartenberg*'s "so disproportionate" standard as the "applicable framework for [its] analysis." Pet. App. 29a. The district court also adopted *Gartenberg*'s analytical rubric, looking to six non-exclusive factors that *Gartenberg* identified as relevant to the "so disproportionate" analysis. Those factors include: (1) the nature and quality of the services rendered; (2) the profitability of the funds to the adviser; (3) economies of scale; (4) comparative fee structures; (5) fallout benefits; and (6) the conscientiousness of the board. *Id.* at 28a (citing *Gartenberg*, 694 F.2d at 929-30).

After examination of "all facts pertinent to the amount of fees paid," the district court held that petitioners had not raised a triable issue of fact on "whether the fees charged to the Funds" during the relevant period were "so disproportionately large that they could not have been the result of arm's-length bargaining." Pet. App. 27a, 29a; see also *id.* at 28a.

The court emphasized that, because advisory fees are the product of negotiation, no single result could be expected: "[T]here is a range of acceptable results." Pet. App. 29a. But there was no "dispute that Harris's fees were comparable to those charged by other similar funds." *Id.* at 30a. Petitioners did not deny that the Funds "performed well"—indeed, extraordinarily well—"during the damages period." *Id.* at 30a, 32a. And there was no genuine dispute that the Funds' trustees "oper-at[ed] without any conflict" that would prevent "arm's-length negotiations" with Harris. *Id.* at 31a. The undisputed facts showed that the "shareholders' interests were represented at the negotiating table by a group of people who were capable of giving those interests primacy." *Ibid.*

The court rejected petitioners' contention that the breakpoints negotiated by the trustees did not adequately share economies of scale with shareholders. The court held that the trustees need not set breakpoints at the lowest possible level, but rather at levels that reflected good-faith, arm's-length negotiation. Pet. App. 31a. Petitioners produced no evidence suggesting that the negotiated results did not meet this standard. The breakpoints were "comparable to what shareholders in other mutual funds had accepted." *Id.* at 31a-32a.

The district court also rejected petitioners' argument that the fees Harris charged the Funds must be substantially similar to fees charged to institutional clients. Pet. App. 30a. The undisputed facts established that Harris provided "more limited" services to institutional clients than it provided to the Funds. *Id.* at 16a.[3] The court fur-

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[3] Petitioners' assertion that the district court ruled that fee differentials for "indistinguishable" services "did not matter," Pet. Br. 13, mischaracterizes the ruling. The court specifically held that the ser-

ther held that, even if one assumed that institutional investors received identical services, the evidence did not show that the fees paid by the Funds exceeded the amount that could have resulted from arm's-length negotiations. The Funds' fees fell comfortably within the range of all fees Harris charged to all client types. *Id.* at 30a. That, the court explained, "prevent[s] a conclusion that the amount of fees indicates that self-dealing was afoot." *Ibid.*

The district court finally reviewed and rejected petitioners' various claims of misconduct, including claims that social and business contacts between members of the board made them "interested," violated other provisions of the ICA, or otherwise tainted the fee negotiations. Pet. App. 24a-26a. First, the court held that petitioners could not shoehorn ostensible violations of other sections of the ICA—sections that are not privately enforceable—into a §36(b) claim. *Id.* at 24a-25a. Moreover, the court held that petitioners' catalogue of supposed intra-board conflicts had no impact on the analysis of a breach of duty "with respect to the receipt of compensation." See *id.* at 25a-26a. "[O]nly an actual conflict that resulted in an identified effect on shareholders' interests" will factor into the §36(b) analysis. *Id.* at 26a. Finally, petitioners' allegations were not proved. The record evidence did not show either that "Harris attempted to exercise" influence

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vices were *not* indistinguishable: The "services Harris provided to institutional clients varied, but in all events *were more limited* than those they provided to the Funds." Pet. App. 16a (emphasis added). The court then noted that, *even if* the services provided were "indistinguishable," the fee differential here was not sufficient to set forth a §36(b) violation, because "the amounts paid by different parties establish a range of prices that investors were willing to pay." *Id.* at 30a.

or that a conflict made it "impossible for the trustees to act without compromising the shareholders." *Ibid.*

Finding no disputed issue of fact as to "whether there is a fundamental disconnect between what the Funds paid and what the services were worth," the court granted summary judgment for Harris. Pet. App. 32a.

C. The Court Of Appeals' Decision

The Seventh Circuit affirmed. Pet. App. 1a-14a. On appeal, petitioners again disavowed *Gartenberg*, and urged the court to review Harris's fees for "reasonableness" instead. *Id.* at 6a. The court of appeals expressed skepticism about *Gartenberg*, and ultimately "disapproved" its approach. But it was not persuaded to adopt petitioners' "reasonableness" requirement. The court explained that §36(b) does not say that "fees must be 'reasonable' in relation to a judicially created standard." *Id.* at 8a. In fact, Congress had rejected a reasonableness requirement. *Id.* at 8a, 10a-11a. The statute instead imposes a fiduciary duty, which "differs from rate regulation." *Id.* at 8a. Under traditional principles, a fiduciary "owes an obligation of candor in negotiation, and honesty in performance," but may negotiate in its own interest with respect to compensation. *Id.* at 8a-9a (citing *Restatement (Second) of Trusts* §242 & cmt. f (1959)). The court cautioned that "[i]t is possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." *Id.* at 9a. But petitioners had not identified facts to support such an inference. *Id.* at 13a-14a. The Seventh Circuit thus refused to disturb the district court's conclusions that petitioners raised no material issue of fact to rebut the record of robust, informed, and independent negotiation, and that the bargain produced rates that fit comfortably within the range cor-

roborated by the "market." *Ibid.* The court of appeals therefore affirmed the district court's judgment that Harris did not breach its "fiduciary duty with respect to the receipt of compensation." *Ibid.*

The court of appeals also refused to disturb the district court's determination that petitioners had raised no genuine dispute about the differences between fees charged to mutual funds and other clients. Pet. App. 13a. Echoing the district court's conclusion that Harris provided "more limited" services to non-mutual fund clients, *id.* at 16a, the court of appeals explained that "[d]ifferent clients call for different commitments of time," different services, and varying degrees of complexity in conducting "research, valuation and portfolio design." *Id.* at 13a. For example, "[p]ension funds have low (and predictable) turnover of assets." *Ibid.* But "[m]utual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions." *Ibid.* Like the district court, the court of appeals rejected the notion that a fiduciary duty encompasses a uniformity requirement for rates. *Ibid.*

The court also rejected the contention that the "captive" relationship between an investment adviser and a fund leads to excessive fees. Pet. App. 7a. Advisers form funds to compete for investor dollars. "[M]utual funds have a powerful reason to keep [fees] low unless higher fees are associated with a higher return on investment." *Ibid.* "That mutual funds are 'captives' of investment advisers does not curtail this competition. An adviser can't make money from its captive fund if high fees drive investors away." *Ibid.* Mutual fund investors can move their investment dollars across thousands of competing funds rapidly and easily, allowing investors to "protect their interests by shopping." *Id.* at 11a-12a. Conse-

quently, even if funds do not fire their advisers, investors "can and do 'fire' advisers cheaply and easily by moving their money" to other funds. *Ibid.*

The court finally rejected petitioners' contentions that ostensible conflicts among the trustees amounted to violations of §36(b). Pet. App. 3a-4a. Echoing the district court, the Seventh Circuit held that claimed violations of other sections of the ICA that do not afford a private right of action cannot be enforced under §36(b). *Id.* at 3a. The court rejected petitioners' suggestion that one trustee (Mr. Morgenstern) was not "disinterested." Even without counting Mr. Morgenstern, the board still exceeded the statutorily required percentage of disinterested directors. *Id.* at 3a-4a. The court discredited petitioners' fallback argument that Mr. Morgenstern's social and business contacts with other trustees made him "posses[s] some Svengali-like sway over the other trustees, so that his presence in the room was enough to spoil their decisions." *Id.* at 4a.

The court of appeals denied rehearing *en banc* by an equally divided vote. The dissenting judges acknowledged that "[t]he *outcome* of this case may be correct." Pet. App. 42a. And they agreed that the panel's conclusion "might not seem to differ materially from" the *Gartenberg* standard. *Id.* at 41a. But the dissenting judges expressed concern that the panel opinion could be read to preclude courts from comparing the adviser's fee to anything but the fees charged to other mutual funds. *Ibid.*

SUMMARY OF ARGUMENT

I. A. For nearly 30 years, the mutual fund industry and the SEC have uniformly accepted the interpretation of §36(b)'s "fiduciary" obligation articulated in *Gartenberg* v. *Merrill Lynch Asset Management Co.*, 694 F.2d 923 (2d Cir. 1982). Under *Gartenberg*, an adviser

breaches its fiduciary duty with respect to the receipt of compensation when it charges a fee that is "so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Id.* at 928.

That standard is faithful to the text, structure, and history of the ICA. In enacting § 36(b), Congress drew upon the common law of fiduciary obligations, which asks whether "under all the circumstances the transaction carries the earmarks of an arm's length bargain." *Pepper* v. *Litton*, 308 U.S. 295, 306-07 (1939). Congress departed from the common law, however, by placing the burden of proof on the plaintiff. The resulting standard is precisely what *Gartenberg* enunciated, requiring the shareholder to prove that the fee could not have been the product of arm's-length bargaining. *Gartenberg*'s approach is also consistent with the ICA, which makes independent boards the "cornerstone" of its "effort to control conflicts of interest within mutual funds," *Kamen* v. *Kemper Fin. Servs.*, 500 U.S. 90, 107 (1991), and directs courts to accord board approval "such consideration * * * as is deemed appropriate under all the circumstances," 15 U.S.C. § 80a-35(b)(2).

B. Petitioners pin their entire case on the theory that adviser fees must be "fair and reasonable," and that any difference between the fees charged to mutual fund clients and institutional clients is dispositive as a matter of law.

1. Petitioners' contention that Congress imported trust-law principles of "fairness and reasonableness" into the term "fiduciary duty" is untenable. Congress knows how to incorporate trust-law concepts into a statute and did not do so here. And those concepts are incongruous

in this context, where the statute erects multiple, independent checks on excessive fees.

2. More important, Congress explicitly *rejected* the standard proposed by petitioners. In the 1970 Amendments, Congress deleted a proposed "reasonableness" standard in favor of "fiduciary duty." Congress did not reject "reasonableness" only to camouflage it in a different phrase.

3. In all events, petitioners' standard makes little practical sense. Since §36(b)'s enactment, the SEC has further strengthened the ICA's stringent requirements for board independence. At the same time, the growth of the mutual fund industry has created a powerful check on fees: Investors are free to transfer their dollars elsewhere. Review of fees for fairness, which courts are ill-equipped to carry out, is not necessary.

C. Petitioners hinge their fairness standard on the claim that different charges to mutual fund clients and institutional clients are legally dispositive. That imposes extra-textual rate regulation in the form of a "most favored price" rule. To be sure, a comparison of fees and services may be germane in some circumstances. But that is plainly not always the case, and it depends upon apt comparisons. Petitioners did not lay the foundation of comparability, as both the district court and court of appeals found. Since the services here are not comparable, there is no justification for making the comparison dispositive.

D. Finally, petitioners assert that §36(b) permits a cause of action where the fee is reasonable, but the fee-setting process was flawed. That finds no support in the the statute, which provides a cause of action only for breaches "with respect to the *receipt of compensation*." Congress did not establish a private right of action in

§36(b) to enforce other provisions of the ICA that do not themselves include a private right of action.

II. Petitioners' proposed standard would provoke enormously costly trials upon the bald assertion that fees were "too high" or a process was somehow flawed. That recipe for unrestrained litigation would benefit lawyers, not investors.

III. The district court properly applied *Gartenberg* to the undisputed facts, and the court of appeals properly declined to disturb those findings. Petitioners' disagreement with the factual findings of both courts supplies no reason to reverse the judgment or to uproot *Gartenberg*'s well-settled and well-respected framework.

ARGUMENT

The Investment Company Act ("ICA") addresses investment adviser compensation through a carefully calibrated and reticulated statutory scheme. To promote robust bargaining, Congress required that management fees be approved annually by a majority of the disinterested directors. 15 U.S.C. §80a-15(a)(2), (c). The ICA and SEC regulations oblige investment advisors to provide, and mutual fund boards to review, extensive disclosures about an adviser's fees, costs, performance, and profits, as well as whether the board relied upon comparisons of the services and charges to other clients. *Id.* §80a-15(c); 69 Fed. Reg. 39,798, 39,808 (June 30, 2004). The Act thus delegates primary responsibility for investment adviser compensation to the fund's independent board members, and equips them with the tools they need to function as informed negotiators and "independent watchdogs." *Burks* v. *Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir. 1977)).

Section 36(b) of the ICA supplements that regime by creating a remedy for an investment adviser's breach of "fiduciary duty with respect to the receipt of compensation." 15 U.S.C. §80a-35(b). Petitioners would construe §36(b) to impose an actionable obligation that fees be "fair and reasonable" in the eyes of a reviewing court, see Pet. Br. 38, and to authorize judicial review of flaws in negotiations detected in hindsight, *id.* at 17 (proposing two-part standard). Those constructions are untenable. Both are inconsistent with the statutory text and structure, the measure's history, and the judicial interpretation of the measure that petitioners purport to champion.

Petitioners acknowledge (Br. 44) that, when Congress imposed a "fiduciary duty with respect to compensation," it rejected prior bills that required adviser compensation to be "reasonable." See S. Rep. No. 184, 91st Cong., 1st Sess. 5-6 (1969) (noting "delet[ion]" of "reasonableness" standard and substitution of "fiduciary duty" as "a different method of testing management compensation"). But petitioners nevertheless insist that the phrase "fiduciary duty" requires fees to be "fair and reasonable." See Pet. Br. 38. They thus take the circular position that Congress implicitly encompassed within the "fiduciary duty" text it enacted the "reasonableness" standard it explicitly rejected.

Petitioners steer this circular path from the premise—ostensibly derived from the law of trusts—that the compensation of "fiduciaries" is always susceptible to judicial review to determine whether it is "fair and reasonable." That is wrong. But in all events, Congress did not transplant fiduciary compensation principles into §36(b) wholesale from the particularized context of trust law. It created a "unique" right, enforceable by the SEC and security holders, *Daily Income Fund* v. *Fox*, 464 U.S. 523,

524 (1984), that both drew upon and modified general fiduciary principles with common-law roots from multiple sources.

The general standard of fiduciary obligation at common law is well established. The "essence of the test" is whether, "under all the circumstances," the result "carries the earmarks of an arm's length bargain." *Pepper* v. *Litton*, 308 U.S. 295, 306-07 (1939). In §36(b), Congress adopted that familiar standard and adapted it to the mutual fund context. At common law, a fiduciary was obliged to justify his fee; in §36(b)(1), Congress reversed the burden of proof and put the onus on the shareholder. 15 U.S.C. §80a-35-b(1). Common law likewise deferred in the corporate context to board decisions with scant regard to the quality of their deliberations. See, *e.g.*, *Saxe* v. *Brady*, 40 Del. Ch. 474, 486 (1962); S. Rep. No. 184, *supra*, at 5. In §36(b)(2), Congress commanded that courts "shall" give board approval the deference that is due "under all the circumstances." 15 U.S.C. §80a-35(b)(2). In short, Congress borrowed the familiar "earmarks of an arm's length bargain" test from common law, and turned it around to oblige a shareholder to show that the fee could *not* have been the product of an arm's length bargain.

That is precisely what the Second Circuit held in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). To violate §36(b), *Gartenberg* stated, "the adviser-manager must charge a fee that is *so disproportionately large that* it bears no reasonable relationship to the services rendered and *could not have been the product of arm's-length bargaining.*" *Id.* at 928 (emphasis added). *Gartenberg*'s holding was thus faithful to the statutory "fiduciary duty 'standard,'" as well as to the statute's directive that courts "shall" accord "approval by

the [mutual fund's] board of directors * * * such consideration * * * as is deemed appropriate under all the circumstances." 15 U.S.C. §80a-35(b)(2). *Gartenberg* honors Congress's intent that the judiciary not "substitute its business judgment for that of the mutual fund's board of directors in the area of management fees." S. Rep. No. 184, *supra*, at 6.

Petitioners purport to embrace *Gartenberg*, observing that it "correctly held" that an adviser violates §36(b) "when it charges a fee that exceeds what could be obtained in an arm's length transaction." Pet. Br. 18. But that about-face from their position in both courts below, see pp. 13, 16, *supra*, is suspiciously selective. Petitioners reject *Gartenberg's* holding—that an adviser "must charge a fee that is so disproportionately large" that it "could not have been the product of arm's length bargaining." Pet. Br. 31 (describing that formulation as "erroneous"). They likewise refuse to accept factors in the "disproportionality" calculus that *Gartenberg* identified as most relevant. Petitioners acknowledge, for example, that "*Gartenberg* 'rejected' a comparison between the fees charged to the money-market fund at issue there and the fees charged to" institutional accounts because (among other things) the institutional accounts "did not 'face the myriad daily purchases and redemptions throughout the nation which must be handled' by the money-market fund." *Id.* at 30 (quoting 694 F.2d at 930 n.3). But petitioners press a similarly inapt comparison on this Court, asking it to equate managing investments for a single institutional account with the sponsorship, operation and management of a mutual fund with hundreds of thousands of investors, related infrastructure and support requirements, daily cash-flow needs, and significant regulatory obligations—none of which exist for

institutional accounts. Indeed, they insist that this Court make such a comparison the overriding consideration as a matter of law, from their question presented forward. Pet. Br. i, 30-31, 48-50. And they layer onto their ersatz espousal of *Gartenberg* the separate contention—found nowhere in *Gartenberg* much less the statute—that an adviser can independently violate §36(b) through negotiation "process" flaws. Pet. Br. 17, 18, 25, 33. Petitioners thus ask this Court to adopt everything in *Gartenberg* except its holding and analysis.

Respondent agrees with the United States that *Gartenberg* supplies the relevant standard for measuring violations of §36(b). See U.S. Br. 11-12 (*Gartenberg* "provides the appropriate way to resolve §36(b) cases"). But *Gartenberg* did not adopt the "reasonableness" standard petitioners propose. This Court should reject petitioners' circular reading of text, their failure to acknowledge statutory structure and history, and their unaffectionate embrace of *Gartenberg*.

I. A MUTUAL FUND ADVISER BREACHES ITS FIDUCIARY DUTY WITH RESPECT TO COMPENSATION ONLY IF IT CHARGES A FEE THAT IS SO DISPROPORTIONATE IT COULD NOT HAVE BEEN THE PRODUCT OF ARM'S-LENGTH BARGAINING

Section 36(b) by its terms provides that investment advisers have a "fiduciary duty with respect to the receipt of compensation." 15 U.S.C. §80-35(b). For nearly 30 years, the "fiduciary" obligation that provision establishes has enjoyed a common understanding by advisers, fund boards, shareholders, regulators and courts. Since the Second Circuit's decision in *Gartenberg*, the industry and the SEC alike have uniformly accepted that, to breach its "fiduciary duty with respect to compensation," an adviser must charge a fee that is "so disproportion-

ately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." 694 F.2d at 928. *Gartenberg's* broad acceptance is attributable to its consistency with the text, structure, and history of the ICA.

Petitioners schizophrenically claim to endorse *Gartenberg* as "correct," Pet. Br. 18, while simultaneously rejecting its "so disproportionate" standard as "erroneous," *id.* at 31. They propose instead that courts subject fees to "rigorous scrutiny" to ensure that management fees are "fair" and "reasonable." *Id.* at 17, 31. And they inject an altogether new "fair process" ingredient to the text's cause of action for improper "receipt" of "compensation." *Id.* at 17, 18, 25, 33. Petitioners thus would have courts examine fees for "reasonableness" and require judicial micromanagement of the fee-negotiating "process," authorizing a remedy even if a flaw detected in hindsight did not impact the result.

Petitioners' proposed replacement of *Gartenberg's* long-established standard with a formula of their own creation is flatly contrary to §36(b)'s text and the ICA's structure. It would afford any plaintiff—including shareholders who knowledgeably bought their shares on full disclosure of fees—the ability to force a trial for a judge to decide after-the-fact if fees were just "too high." That is a recipe for unrestrained litigation that the statute did not countenance and this Court should not provoke.

A. *Gartenberg*'s "So Disproportionate" Test Properly Interprets §36(b)'s Text And Structure

In enacting §36(b)'s "fiduciary duty with respect to the receipt of compensation," Congress consciously navigated between two extremes. On the one hand, Congress rejected the "reasonableness" standard initially proposed by the SEC and passed by the Senate. *Daily Income*

Fund, 464 U.S. at 538-39; S. Rep. No. 184, *supra*, at 5; H.R. Rep. No. 2337, 89th Cong., 2d Sess. 142-44 (1966). That test was "offensive to many" because it smacked of "fee-setting" and authorized courts to "substitute" their judgment for and "supersede" decisions of informed boards. 115 Cong. Rec. 13,693 (May 26, 1969). On the other hand, Congress concluded that prevailing "waste" standards were "unduly restrictive" because they prevented only shocking fees and accorded near-absolute deference to board approval. S. Rep. No. 184, *supra*, at 5. Congress therefore created a "unique" right, *Daily Income Fund*, 464 U.S. at 524, by adopting a federally-created "fiduciary duty" standard with common-law roots. In adopting a phrase with common-law origins, however, Congress did not transplant into the statute the specific law of trusts, as petitioners contend. It drew on general fiduciary principles that married content to context. And it modified those principles to tailor them to "the unique structure of mutual funds." S. Rep. No. 184, *supra*, at 2; see *id.* at 5.

1. This Court interprets statutes in light of "text, structure, purpose, and history." *General Dynamics Land Sys., Inc.* v. *Cline*, 540 U.S. 581, 600 (2004). *Gartenberg*'s interpretation of §36(b)'s "fiduciary duty with respect to the receipt of compensation" reflects the statute's text and is faithful to congressional intent. Where, as here, the statute invokes terms with settled common-law meanings, this Court assumes Congress intended to incorporate those meanings except as the statutory text, structure, or context otherwise indicates. *Neder* v. *United States*, 527 U.S. 1, 21 (1999). As *amicus curiae* Securities Industry and Financial Markets Association ("SIFMA") explains at length, the common law of "fiduciary duties" related to compensation is extensive, varied,

and context-sensitive; its standards are adaptable in light of the nature of the fiduciary relationship, the source of the obligation, the parties' bargaining power, and other factors. But all parties and the United States agree that the fundamental consideration was expressed by this Court in *Pepper* v. *Litton*, 308 U.S. 295 (1939): "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." *Id.* at 306-07; see U.S. Br. 11; Pet. Br. 23-25. Because a fiduciary bore the burden of proof at common law,[4] the principle drawn from *Pepper* would oblige an investment manager to justify its fees as falling within the range that informed bargaining would produce. Section 36(b)(1), however, reverses the common-law burden of proof. The statute puts the onus on the challenger, declaring that "the plaintiff shall have the burden of proving a breach of fiduciary duty." 15 U.S.C. §80a-35(b)(1). As a result, the shareholder must prove that, under "all the circumstances," an investment adviser has charged fees that do *not* "carr[y] the earmarks of an arm's length bargain." *Pepper*, 308 U.S. at 306-07.

Gartenberg imposes precisely that requirement. It assigns to a shareholder the responsibility to demonstrate that an adviser's fee is "so disproportionate" that it "could not have been the product of arm's-length bargaining." *Gartenberg*, 694 F.2d at 928. *Gartenberg* thus incorporates *Pepper*'s "essen[tial] * * * test" of an "arm's-length bargain," and implement's §36(b)(1)'s directive to reverse the burden of proof.

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[4] At common law, a fiduciary ordinarily bore the burden of justifying its fees if challenged. See, *e.g.*, *Pepper*, 308 U.S. at 306; cf. *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921) ("[W]here the fairness of such transactions is challenged the burden is upon those who would maintain them * * * .").

2. The *Gartenberg* formulation, moreover, properly incorporates the other features of the statutory text that adapt fiduciary principles to the mutual fund context. When plotting the course between "reasonableness" and "waste," Congress rejected waste-based standards that accorded extreme deference to boards even if they rubber-stamped the adviser's request. S. Rep. No. 184, *supra*, at 5. Congress departed from unqualified respect for board conduct and commanded that courts "shall" give board approval "such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. §80a-35(b)(2).

That directive reflects the ICA's overall structure, which makes independent boards "the cornerstone of the ICA's effort to control conflicts of interest within mutual funds," *Kamen* v. *Kemper Fin. Servs.*, 500 U.S. 90, 107 (1991) (quoting *Burks*, 441 U.S. at 482), and interposes them as "independent checks" against excessive fees, *Daily Income Fund*, 464 U.S. at 540. As explained above, the ICA mandates that 40 percent of a board's fund members be "disinterested" with respect to the investment adviser and that any agreement with the investment adviser be approved every year by a majority of disinterested board members. See 15 U.S.C. §§80a-10(a), 15(c). "Congress' purpose in structuring the Act this way is clear. It placed the unaffiliated directors in the role of 'independent watchdogs,' who would 'furnish an independent check upon the management' of investment companies." *Burks*, 441 U.S. at 484 (citations omitted). The Act also requires investment advisers to provide, and boards to review, a wealth of materials to assist in their annual contract evaluation. See p. 4, *supra*. That statutory process yields vast amounts of information that would rarely be available in a typical arm's-length nego-

tiation. No arm's length negotiator would typically know its counterparties' costs, profits, and agreements with other companies. But mutual fund boards do. Fund boards negotiate from a position that is *better* than arm's-length. They have the independence they need to make demands, and superior information that gives them an advantage other negotiators customarily lack.

Section 36(b)(2) reflects the board's "cornerstone" role in the statutory structure. Departing from the common law, that provision's directive that courts give the board's determination the weight it is due proposes that courts ask whether "deliberations * * * were a matter of substance or a mere formality." H.R. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970); S. Rep. No. 184, *supra*, at 15. But where fund directors engage in substantive review, courts should respect their primacy as "independent watchdogs." *Burks*, 441 U.S. at 484. It is precisely because of that primacy that the court is not authorized "to substitute its business judgment for that of the mutual fund's board of directors." S. Rep. No. 184, *supra*, at 6. In short, courts need not defer to directors who are asleep at the wheel, but judges cannot "shift the responsibility for managing an investment company in the best interests of its shareholders from the directors of such company to the judiciary." *Id.* at 7.

Gartenberg's appropriation of *Pepper's* "earmarks of an arm's-length bargain" properly applies § 36(b)(2)'s directive. *Gartenberg* captures the deference that federal courts owe to the business judgment of the board while making clear that deference is not owed to directors who fail to engage in substantive review. 694 F.2d at 930. And it properly reflects the Act's structural delegation of primary responsibility to directors and the proscription on courts' exercising independent business judgment.

3. *Gartenberg* has been consistently applied. Courts in the First, Second, Third, Fourth, Fifth, and Ninth Circuits have cited *Gartenberg* as authority, often adopting its standard and factors explicitly.[5] That near-universal acceptance over a period spanning 25 years is unsurprising given *Gartenberg*'s origins in familiar fiduciary concepts, as modified by Congress for application in the mutual fund context.

The SEC has also effectively adopted *Gartenberg* as the embodiment of §36(b)'s "fiduciary duty." As the Solicitor General explains, "[t]he SEC's regulations have recognized, and formalized, *Gartenberg*-like factors." U.S. Br. 23; see, *e.g.*, *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, 69 Fed. Reg. 39,798, 39,807-09 (2004) (requiring discussion of *Gartenberg*-like factors in mutual fund disclosures about fees). Indeed, the Commission has frequently cited *Gartenberg* to suggest that fees "must fall within the range of what would have been negotiated by the parties at arm's length." SEC No-Action

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[5] See, *e.g.*, *Forsythe* v. *Sun Life Fin., Inc.*, 417 F. Supp. 2d 100, 114 (D. Mass. 2006) ("In *Gartenberg*, the Second Circuit set forth a standard that has since been widely cited by other courts in addressing claims under §36(b)."); *Yameen* v. *Eaton Vance Distrib.*, 394 F. Supp. 2d 350, 355 (D. Mass. 2005) (applying *Gartenberg*); *Amron* v. *Morgan Stanley Inv. Advisers, Inc.*, 464 F.3d 338, 340-41 (2d Cir. 2006) (applying *Gartenberg*); *In re Franklin Mut. Funds Fee Litig.*, 478 F. Supp. 2d 677, 686 (D.N.J. 2007) (applying *Gartenberg*); *Migdal* v. *Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 326 (4th Cir. 2001) (describing *Gartenberg* as having "exhaustively analyzed Section 36(b)" and citing its standard); *Hunt* v. *Invesco Funds Group, Inc.*, No. 04-2555, 2006 WL 1581846, at *2 (S.D. Tex. June 5, 2006) (applying *Gartenberg*); *Siemers* v. *Wells Fargo & Co.*, No. 05-4518, 2006 WL 2355411, at *15-16 (N.D. Cal. Aug. 14, 2006) (applying *Gartenberg*).

Letter, Norwest Bank Minnesota, 1995 WL 329622, at *4 (May 25, 1995) (citing *Gartenberg*).

Thus, as Commissioner Troy Peredes recently observed, "*Gartenberg* has long served as a constructive focal point for the mutual fund industry, as norms and practices have developed around the *Gartenberg* factors * * *. Even the SEC has incorporated *Gartenberg* in its rulemaking." Speech by SEC Commissioner: Remarks Before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 4, 2009), *available at* http://www.sec.gov/news/speech/2009/spch050409tap.htm; see also SEC Div. of Inv. Mgmt., *Report on Mutual Fund Fees and Expenses* (Dec. 2000), *available at* http://www.sec.gov/news/studies/feestudy.htm (in §36(b) cases, courts determine whether the adviser charged a fee "that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining"); SEC Div. of Inv. Mgmt., *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992), *available at* http://www.sec.gov/divisions/investment/guidance/icreg5092.pdf (*Gartenberg* "remains the leading authority for evaluating an adviser's breach of fiduciary duty with regard to compensation"). The *Gartenberg* standard and factors likewise have been adopted throughout the industry because they "provide[] useful guidance to fund boards fulfilling their obligation under Section 15(c) of the ICA of evaluating advisers' compensation" as well as "guidance for advisers in proposing fees." U.S. Br. 24.

B. Petitioners' Proposed "Fair And Reasonable" Standard Is Inconsistent With §36(b)'s Text, Structure, And History

In contrast to *Gartenberg*'s requirement that fees be "so disproportionate" they "could not have been" the pro-

duct of arm's-length bargaining, petitioners propose that federal courts subject advisory fees to "rigorous scrutiny" to ensure that they are "fair and reasonable." Pet. Br. 17, 25, 28, 31, 33. That open-ended license for judicial revision to adviser compensation is precisely what Congress rejected. The text, structure, and history of § 36(b) all show petitioners' approach to be untenable. It is not surprising that no court has ever adopted petitioners' approach.

1. *Section 36(b)'s Text and Structure Defy Petitioners' Construction*

Petitioners' "fair and reasonable" standard proceeds from the indefensible premise that Congress incorporated principles drawn from the specialized law of trusts, and transplanted them wholesale by using the words "fiduciary duty." Pet. Br. 20-25. To be sure, "[w]here Congress uses terms that have accumulated settled" common-law meaning, "a court must infer, unless the statute otherwise dictates, that Congress means to incorporate the established meaning of these terms." *Id.* at 20 (quoting *Neder* v. *United States*, 527 U.S. 1, 21 (1999)). But the phrase "fiduciary duty" does not refer only to the common law of trusts. The scope of any fiduciary obligation derives from its context. Cf. *SEC* v. *Chenery Corp.*, 318 U.S. 80, 85-86 (1943) ("[T]o say that a man is a fiduciary only begins analysis; it gives direction to further inquiry.") (emphasis added). Different fiduciary contexts may require different compensation rules; courts reject thoughtless transplantation. See, *e.g.*, *Mfrs. Trust Co.* v. *Becker*, 338 U.S. 304, 311-12 (1949) (declining to apply trust law concepts to directors of insolvent corporation). Even petitioners' *amici* agree. See Br. of Professors DeMott and Ascher 4 ("Fiduciary doctrine is not mono-

lithic in its operation. Thus, the duty of loyalty applicable to some fiduciaries operates with greater stringency.").

Petitioners identify nothing in §36(b)'s text that signals an intent to import the law of trusts into judicial review of investment adviser compensation. Neither the statute nor its legislative history invoke—or even mention—trust law. Surely Congress knows how to incorporate trust concepts into a statute; it has often done so. See, *e.g.*, 29 U.S.C. §1103(a) (ERISA defines plans as "held in trust," appoints administrator as "trustee," and mandates "trustees" be "named in the trust"); *Cent. States, Se. & Sw. Areas Pension Fund* v. *Cent. Transp., Inc.*, 472 U.S. 559, 570 (1985) (ERISA "invoked the common law of trusts to define the general scope" of the "powers and duties of trustees and other [ERISA] fiduciaries"). But it did not do so here, either expressly or by implication.

If Congress had intended to incorporate a specific trust-law standard, it could have required investment adviser compensation to be "fair" or "reasonable." It did precisely that in *other* provisions of the ICA. See, *e.g.*, 15 U.S.C. §80a-17(b) (authorizing transactions with affiliates only if "the terms * * * , including the consideration to be paid or received, are *reasonable and fair* and do not involve overreaching on the part of any person concerned") (emphasis added); *id.* §80a-26(f)(2)(A) (registered account funding variable insurance contracts is permitted only if "the fees and charges * * *, are *reasonable* in relation to the services rendered, the expenses expected to be incurred, and the risks assumed by the insurance company" or if other conditions are met) (emphasis added); *id.* §80a-27(a)(5) & (6) (fees for periodic payment plan certificates must not "exceed[] such *reasonable amount* as the Commission may prescribe") (em-

phasis added); see also 15 U.S.C. §80a-10(d)(6) (capping fees in certain situations). The use of the terms "fair" and "reasonable" elsewhere in the ICA—but *not* in §36(b)—is compelling evidence that Congress did not incorporate "reasonableness" review into advisory compensation claims. *Bates* v. *United States*, 522 U.S. 23, 29-30 (1997) ("[W]here Congress includes particular language in one section of a statute but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.").

Petitioners' claim that §36(b) imports trust-law concepts is also irreconcilable with the ICA's structure, which makes independent and informed board members "the cornerstone of the ICA's effort to control conflicts of interest within mutual funds," *Kamen*, 500 U.S. at 107, and an "independent check[]" on excessive advisory fees, *Daily Income Fund*, 464 U.S. at 540. Section 36(b)(2)—which petitioners virtually erase from the text—instructs courts to accord board determinations the weight due under the circumstances. 15 U.S.C. §80a-35(b)(2). But if the standard for judicial review were "reasonableness," Congress would have had no reason to issue that command of deference. Section 36(b)(2) was necessary only because Congress rejected "waste" standards that discounted board deliberations. A "reasonableness" standard that lies in the eyes of the judicial beholder makes §36(b)(2) meaningless. A court cannot simultaneously comply with the statutory directive that it "shall" give directors' decisions such deference as they are due, and decide for itself whether fees are too high, too low, or just right—which is what review for "reasonableness" necessarily connotes.

The ICA's independence and disclosure requirements together promote robust negotiations that are *better* than bargains reached at arm's-length. In sharp contrast, in the trust-law context, judicial scrutiny of "fairness" was warranted when expert and independent negotiators did *not* exist to protect the beneficiary's interests. See, *e.g.*, *Restatement (Second) of Trusts* § 242 & cmt. f (1959). It is inconceivable that Congress transplanted trust law into this foreign soil without saying so.

2. *The Act's History Refutes Petitioners' Construction*

Congress specifically considered and rejected the standard of reasonableness that petitioners propose. See *Daily Income Fund*, 464 U.S. at 538-39. In 1968, at the SEC's urging, see H.R. Rep. No. 2337, *supra*, at 142-44, the Senate passed a bill that would have required mutual fund advisory fees to be "reasonable" and granted shareholders standing to enforce that obligation. S. Rep. No. 184, *supra*, at 5. But in the 1970 Amendments, Congress dropped the "reasonableness" requirement. *Ibid.* By espousing "reasonableness" as their touchstone, petitioners contend that Congress explicitly rejected that standard only to adopt it *sub silentio* within the phrase "fiduciary duty."

But Congress did not enact circular synonyms. It specifically "substitute[d]" "reasonableness" with "fiduciary duty" as a "*different* method of testing management compensation." S. Rep. No. 184, *supra*, at 5 (emphasis added). "Congress consciously chose to address the conflict-of-interest problem through the Act's independent-directors section, rather than through more drastic remedies" such as reasonableness review. *Burks*, 441 U.S. at 483; see also *id.* at 484 ("Congress turned not to direct controls, but rather to stiffening the requirement of in-

dependence as the way to remedy the act's deficiencies." (citations omitted)). Petitioners' proposed standard would replace that legislative resolution with the sort of judicial second-guessing that Congress rejected.

As the United States explains, Congress's decision to use the words "fiduciary duty" rather than "reasonableness" reflects its intent to preclude judges from serving as "super-trustees" or ratemakers. See U.S. Br. 23 n.6; S. Rep. No. 184, *supra*, at 6 ("Nothing in this bill is intended to * * * suggest that a 'cost-plus' type of contract would be required" or "to introduce general concepts of rate regulation * * * "). And for good reason. Federal courts are ill-equipped to engage in the sort of rate regulation petitioners propose. *Pac. Bell Tel. Co.* v. *LinkLine Commc'ns*, 129 S. Ct. 1109, 1121-22 (2009); *Verizon Commc'ns* v. *FCC*, 535 U.S. 467, 539 (2002); *Town of Concord* v. *Boston Edison Co.*, 915 F.2d 17, 25 (1st Cir. 1990) (Breyer, C.J.) ("[H]ow is a judge or jury to determine a 'fair price'?"). Petitioners' "fair and reasonable" standard flatly contradicts the construction the United States proposes.

3. *Petitioners' Fairness Standard Makes Little Sense in Light of Regulatory and Market Developments Since the ICA's Enactment*

Petitioners' "fair and reasonable" standard is also nonsensical as a practical matter. Since § 36(b)'s enactment (and even since *Gartenberg* was decided), the SEC has further reinforced the ICA's already "strengthened" requirements for board independence. *Daily Income Fund*, 464 U.S. at 538. The SEC has fleshed out the general disclosure-and-approval provisions of § 15(c) by requiring boards to disclose to shareholders their consideration of the *Gartenberg* factors and the weight they accorded them. SEC, Disclosure Regarding Approval of Invest-

ment Advisory Contracts by Directors of Investment Companies (June 23, 2004), http://www.sec.gov/rules/final/33-8433.htm. The business judgment of a board that complies with the SEC's comprehensive regulatory requirements thus will be entitled to substantial deference under §36(b)(2). It would be a monumental waste of judicial and private resources to subject fund advisers to *de novo* relitigation of the very factors already considered by an independent and informed board.

The growth of an extraordinarily competitive mutual fund market also militates against reading the term "fiduciary duty" to impose judicial rate regulation. Thousands of mutual funds compete for investor dollars. Dissatisfied investors are free to transfer their dollars elsewhere. And empirical evidence shows that they often do, as low-fee funds have experienced tremendous growth, while higher-fee funds have shrunk. Growth, in turn, has prompted a steep and steady decline in fees across the industry. See p. 7, *supra*. In light of that fierce competition, charging fund fees that are generally consistent with comparable funds cannot reasonably be thought to be overreaching. Cf. William A. Gregory, *The Law of Agency and Partnership* §87 (3d ed. 2001) (absent agreement, courts look to market rates to set fiduciary compensation). Rate regulation may be proper for other industries like utilities or natural monopolies. But it is inconceivable that Congress meant to inflict it on a competitive market under the auspices of an adviser's "fiduciary duty."

C. Comparison with Institutional Clients Is Relevant Only When the Adviser Provides Comparable Services

A cornerstone of petitioners' position is that a plaintiff can prove a §36(b) claim by showing that an adviser

charges more to mutual fund clients than to institutional clients like pension funds. Pet. Br. i, 30-31, 48-50. But that effort to require equal charges to different clients suffers from twin defects. First, it betrays petitioners' "reasonableness" test as an undisguised effort to impose judicial rate regulation. Second, it rests upon the rickety foundation that services to disparate clients are comparable. The first proposition we have shown to be inconsistent with legislative text, structure and history. See pp. 33-38, *supra*. The latter notion was rejected on undisputed facts by the district court, and left undisturbed by the court of appeals. The same contention has frequently been advanced and rejected by other courts, including *Gartenberg*, 694 F.2d at 930 n.3.

The district court and court of appeals both perceived that institutional-client fees are potentially probative only if the services provided to the mutual fund and the institutional client are comparable. The district court held that petitioners failed to raise a triable dispute on that issue. Pet. App. 16a ("The services Harris provided to institutional clients varied, *but in all events were more limited* than those they provided to the Funds.") (emphasis added). The district court further held that, *even if* the services were comparable, the difference in fees was insufficiently large to demonstrate a breach of §36(b)'s fiduciary duty. *Id.* at 30a. Rather, together with fees charged by other advisers to comparable mutual funds, the fees charged to institutional clients demonstrated the range of fees that investors were willing to pay. *Ibid.* Because Harris's fees fell within that range, the district court correctly concluded that the fees were not so disproportionate as to evidence a lack of arm's length bargaining. *Ibid.*

The court of appeals agreed that the services Harris provided to institutional clients were not comparable and therefore found the price differential irrelevant. "Different clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions." Pet. App. 13a. Petitioners' disagreement is thus with both lower courts' determinations that the services were not comparable, not with any legal standard that excludes consideration of institutional-client fees.

Petitioners' claims that the institutional-client comparison is "highly probative" and "highly pertinent," Pet. Br. 31, thus cannot apply in all cases, or even most. Section 36(b) provides no mandate for courts to demand that mutual fund fees match some institutional fee. And the "most-favored-pricing" rule that petitioners seek to impose ignores the substantial differences that exist between mutual funds and other accounts. To be sure, an investment adviser provides portfolio management services for both types of accounts, including security selection, research, trading and asset allocation. See J.A. 145. But the similarities largely end there. See Investment Company Institute, *Mutual Funds and Institutional Accounts: A Comparison* 1, 7 (2006) ("Comparison Study"), available at http://www.anbid.com.br/institucional/documentos_download/Fundos/Estudos%20e%20Estat%C3%ADsticas%20Mundiais/ICI%20-%20Mutual%20Funds%20and%20Institutional%20Accounts.pdf. In addition to portfolio management, Harris provides a host of services that are unique to its role as the sponsor and manager of the Oakmark family of mutual funds. These include, among other things, administrative services; shareholder communications, including the preparation and distribu-

tion of prospectuses and periodic reports; oversight of third-party vendors, including the transfer agent, custodian, and intermediaries; trustee support, including preparation of materials for board meetings; tax administration; and compliance with a complex regulatory regime that is not required for institutional accounts. J.A. 145.

Even those different services do not fully catalog the differences between clients, services, and costs that may impact fees. Mutual funds serve thousands to millions of investors with small individual accounts; institutional accounts by definition serve few investors with large balances. See Comparison Study at 4. The scope of mutual fund regulation is extensive. The ICA and other federal securities laws subject funds and their advisers to broad compliance and regulatory obligations. In addition to periodic disclosure requirements, funds must be priced daily, comply with a range of portfolio limitations and restrictions (*e.g.*, "fundamental" objectives, concentration requirements, limits on illiquid holdings, and restrictions on affiliate transactions), comply with Sarbanes-Oxley, and disclose proxy votes. *Id.* at 6. Significantly, those requirements pose legal and business risks to investment advisers they do not face from institutional accounts. Even portfolio management is different, as mutual funds are subject to large and uncertain cash flows, must meet daily redemption demands, and are actively managed to minimize taxable distributions to shareholders. *Id.* at 6-7. In the face of such disparities—which the Funds' trustees specifically reviewed, see J.A. 146, 161-81—petitioners' claim that price discrepancies should be dispositive is indefensible.[6]

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[6] It is therefore unsurprising that courts have consistently refused to find the comparison apt. See, *e.g.*, *Gartenberg*, 694 F.2d at 930 n.3; *Kalish* v. *Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1237 (S.D.N.Y.

That is not to say that a comparison is always irrelevant. Once the foundational predicate of comparability is established, such a review may be germane. For precisely that reason, the independent directors in this case *did* evaluate data to weigh institutional services and fees against mutual fund counterparts. J.A. 146, 152-81. Petitioners' insistence that courts must reweigh a comparison the board has already considered illustrates the defect in their position—they seek to replace the board's judgment with a court's, precisely the result Congress sought to avoid.

The United States agrees that the comparison must be taken on a case-by-case basis, see U.S. Br. 20-21, 30-32, but criticizes the district court for treating similarities with other mutual funds as "dispositive," *id.* at 31. That misdescribes what the district court did. The district court examined the comparison between mutual fund and institutional account fees, and concluded on the undisputed facts that the services were different. Harris supplied "more limited" services to institutional clients than it provided to the Funds. Pet. App. 16a. But the district court did not consider the dissimilarity dispositive. Rather, it considered the difference in light of "all the circumstances," including the board's process and independence. *Id.* at 30a-32a (describing board processes). Finally, rather than hinging its conclusion on the different services, the court held that, "even if" one assumed

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1990) ("Under the cases, to the extent that comparisons are probative at all, a mutual fund adviser-manager must be compared with members of an appropriate universe: adviser-managers of similar funds."); *Schuyt* v. *Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 974 n.38 (S.D.N.Y. 1987) (finding that "the types of services provided by the Adviser to the Fund and private counsel clients differ substantially").

services to be identical, the evidence did not show that the fees paid by the Funds exceeded the amount that could have resulted from arm's-length negotiations. The Funds' fees fell comfortably within the range of all fees Harris received from *all* types of clients. *Id.* at 30a.

To the extent the United States disagrees with the district court's application of the summary judgment standard, that criticism is not justified by the record. The petitioners' "evidence" of comparability sought to equate each of the Funds—with varying asset levels, distinct investment strategies, and different service requirements—to a *single*, allegedly comparable institutional account. J.A. 356. And petitioners ignored any services provided to the mutual funds that were different from or in addition to those rendered to the institutional account. *Id.* at 161-82. If the weight to be given to the comparison with institutional accounts must be determined on a case-by-case basis, this case is the poster child for affording the comparison no weight.

As the United States acknowledges (Br. 26, 30), Congress was well aware that advisers often charged institutional clients lower fees than mutual funds, and that they did so because mutual funds require additional services. See *Daily Income Fund*, 464 U.S. at 537. Indeed, the SEC's 1966 Report to Congress explained that advisers charge mutual funds higher fees because "[p]ublicly held mutual funds *require certain services that are not needed by other purchasers of investment advice.*" H.R. Rep. No. 2337, *supra*, at 11 (emphasis added); see *id.* at 116, 120-21. Yet Congress stated that the amendments to § 36 were *not* "intended to provide a basis * * * to undertake a general revision of the practices or structures of the investment company industry." H.R. Rep. No. 1382, *supra*, at 37.

Petitioners' suggestion that federal courts should parse the complex and varied services provided to different clients, allocate joint costs between clients, and then determine whether the fees charged to the funds are "fair," assigns to judges a task they are ill-equipped to execute. As the United States also recognizes, SEC regulations now require boards to disclose to shareholders the weight they accord comparative fees charged to institutional clients during the fee-approval process. U.S. Br. 30. Under § 36(b)(2), expert boards—not federal courts—are entrusted to evaluate this data in the first instance.

D. Petitioners' Proposed Fair-Process Test Is Unsupported by § 36(b)'s Text

In addition to claiming that § 36(b) obliges federal courts to determine if adviser *fees* are "fair," petitioners assert that § 36(b) authorizes a remedy if an adviser failed to make "full disclosure [to the board] and ensure that the dealings are fair." Pet. Br. 18. Petitioners argue that nearly every court in the decades following *Gartenberg* misconstrued that decision by requiring plaintiffs to actually prove excessive *fees*, as opposed to some flaw in the fee-setting *process*. Petitioners again ignore statutory text and structure.

1. Section 36(b) creates a "fiduciary duty with respect to *the receipt* of compensation" and a corresponding cause of action "for breach of fiduciary duty in respect of *such compensation*." 15 U.S.C. § 80a-35(b). The statutory obligation, by its terms, does not extend to the process of disclosure and negotiation by which fees are approved. "As the statutory text indicates, Section 36(b) is sharply focused on the question of whether the fees themselves were excessive." *Migdal* v. *Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321, 328 (4th Cir. 2001)

(Wilkinson, C.J.). Only the *receipt* of disproportionate compensation can violate the §36(b) duty. An imperfect process that does not result in the receipt of disproportionate fees cannot give rise to a claim under §36(b). *Id.* at 329 ("General breach of fiduciary duty claims which involve merely an incidental or speculative effect on advisory fees are not properly within the scope of Section 36(b).").

By misreading the statutory text, petitioners would create a cause of action that Congress declined to provide. The ICA regulates the negotiation process in multiple ways, and the 1970 Amendments "strengthen[ed]" that process by enhancing board independence and supplying tools to assist boards to do their jobs. See p. 4, *supra*. In particular, §15(c) of the ICA requires investment advisers to disclose to the board all the information necessary to evaluate the terms of any advisory contract. 15 U.S.C. §80a-15(c); p. 4, *supra*. But Congress did not establish a private right of action for breach of §15(c)'s disclosure obligation. Rather, Congress left enforcement of that requirement in the hands of the SEC. 15 U.S.C. §80a-41. Petitioners' argument effectively asks this Court to imply a private right of action to enforce §15(c)'s obligations through §36(b)—even though Congress could have but chose not to provide a private cause of action under §15(c) itself. Cf. *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 571-72 (1979) (no private right of action available where Congress did not provide one, particularly where the provision at issue "is flanked by [other] provisions * * * that explicitly grant private causes of action"); *Transam. Mortgage Advisors* v. *Lewis*, 444 U.S. 11, 20-21 (1979) (no private right of action under IAA).

Section 36(b)(3), moreover, limits "[a]ny award * * * to the *actual damages* resulting from the breach of fiduciary duty." 15 U.S.C. §80a-35(b)(3) (emphasis added). The statute links a "breach of fiduciary duty with respect to the *receipt* of compensation" to measurable damage. Petitioners' claim to a remedy for ostensible "process" flaws the district court held not to exist, and without a measurable fee impact, runs afoul of that statutory limit. Cf. *Doe* v. *Chao*, 540 U.S. 614, 621 (2004) (allowing plaintiff to recover under "actual damages" provision without proving damages would be "at odds with the traditional understanding that tort recovery requires not only wrongful act * * * but proof of some harm for which damages can reasonably be assessed").

Congress provided a different enforcement scheme for adviser misconduct unrelated to a fee itself by investing sole enforcement authority in the SEC. Section 36(a) authorizes the SEC to address breaches of fiduciary duty that involve "personal misconduct." 15 U.S.C. §80a-35(a). And that measure expressly targets both investment advisers and board members—both participants in the fee-setting process. The SEC's enforcement arsenal for combating negotiation flaws, including misleading disclosures, also includes other provisions of the ICA and IAA. See, *e.g.*, *In re New York Life Inv. Mgmt. LLC*, Release Nos. 2883 & 28747 (May 27, 2009), *available at* www.sec.gov/litigation/admin/2009/ia-2883.pdf (cease-and-desist order and sanctions for misleading disclosures to board in violation of, *inter alia*, ICA §15(c)); see also 15 U.S.C. §§80a-41, 80b-9. Congress surely did not tacitly incorporate into §36(b) a private right of action for misconduct that is subject to express enforcement by other means.

It is thus unsurprising that courts have frequently recognized that §36(b) is triggered only by the receipt of excessive compensation, and not by events that occur during negotiations. *Gartenberg*, 694 F.2d at 928; *Migdal*, 248 F.3d at 328-29 (Wilkinson, C.J.) ("Section 36(b) is limited to cases where there was excessive compensation."); see also *Krantz* v. *Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140, 144 n.2 (3d Cir. 2002) ("By definition, a violation of Section 36(b) encompasses excessive payments to the fund's advisers."); *Bellikoff* v. *Eaton Vance Corp.*, 481 F.3d 110, 118 (2d Cir. 2007) ("[O]ne must allege excessive fees, rather than fees that might simply be described as 'improper.'").

2. That is not to say that an adviser or board member's misconduct during the fee-approval process is irrelevant. Section 36(b)(2) insists that board approval "shall" be given such consideration as is "appropriate under all the circumstances." 15 U.S.C. §80a-35(b)(2). But that inquiry is explicitly tied to fees. Judicial inquiry into whether a board's deliberations were "substance" or "formality" "would not be controlling in determining whether or not the fee encompassed a breach of duty." H.R. Rep. No. 1382, *supra*, at 37. Thus, an adviser's failure to make required disclosures or the board's failure to engage in substantive review would surely constitute a "circumstanc[e]" influencing the degree of judicial deference to board approval. But that lessened deference does not relieve a plaintiff's fundamental burden to show that a fee is so disproportionate that it could not have been the product of arm's-length negotiation. Process failures that do not culminate in "disproportionate" fees are not actionable. See *Gartenberg*, 694 F.2d at 928; *Migdal*, 248 F.3d at 329 (Wilkinson, C.J.). Otherwise, every conceivable alleged defect in negotiations would necessitate a

trial. Judicial micromanagement of negotiations is incompatible with Congress's concern that judges not "substitute [their] judgment for that of the [board]," so long as "the deliberations of the directors were a matter of substance" rather than "a mere formality." S. Rep. No. 184, *supra*, at 5, 15; see H.R. Rep. No. 1382, *supra*, at 37.

3. Petitioners claim to derive their fair-process test from the common law. But as noted above, §36(b) does not create a private right of action to enforce *any* common-law "fiduciary duty" against the adviser. Nor does it simply replicate the specific law of trusts. It creates a strictly limited fiduciary duty "with respect to the receipt of compensation," one that provides only for actual damages caused by disproportionate fees. *Green* v. *Fund Asset Mgmt., L.P.*, 286 F.3d 682, 685 (3d Cir. 2002) (Section 36(b) "was intended to provide a very specific, narrow federal remedy that is more limited than the common law doctrines."); *Green* v. *Nuveen Advisory Corp.*, 295 F.3d 738, 743 (7th Cir. 2002) ("Congress enacted §36(b) to provide a narrow federal remedy that is significantly more circumscribed than common law fiduciary duty doctrines." (citation omitted)).

The only case that lends support to petitioners' "fair process" standard is the Eighth Circuit's recent decision in *Gallus* v. *Ameriprise Financial, Inc.*, 561 F.3d 816 (8th Cir. 2009). The fact that the only decision supporting petitioners' view comes nearly three decades after the statute's enactment—and in one of the dozen cases simultaneously initiated, see p. 8 n.2, *supra*—is telling in itself. In any event, the Eighth Circuit's *Gallus* decision fails to analyze how that standard is consistent with §36(b)'s text or the ICA's structure. See *Gallus*, 561 F.3d at 822-23. And the mutual fund adviser in *Gallus* has now filed a petition for a writ of certiorari in this

Court. See *Ameriprise Fin., Inc.* v. *Gallus*, No. 09-163 (petition filed Aug. 6, 2009).

II. PETITIONERS' PROPOSED TWO-PART STANDARD WOULD IMPOSE EXTRAORDINARY BURDENS ON INVESTMENT ADVISERS WITHOUT COMMENSURATE BENEFITS TO INVESTORS

Petitioners' proposed standard of "fair and reasonable" review of both fees and process would injure the very shareholders whose interests they claim to champion. The standard would effectively foreclose the ability to dispose of cases on the pleadings or at summary judgment, and would compel judges to second-guess both rates and negotiations. The ostensible benefits from such judicial scrutiny are measurable for shareholders in grains off a penny, but they come at the cost of substantial resources devoted to expansive litigation.

A. Petitioners' Proposed Standard Dooms Any Fund to Trial

Petitioners' two-part standard would entitle a shareholder to a trial on any claim that fees were "too high" or the process somehow "unfair."

Petitioners' "fair fees" prong would almost always require a trial because it would be next to impossible to prove on summary judgment that fees are "fair" or "reasonable." Indeed, petitioners provide no content to their fairness standard. Any plaintiff or retained expert could quibble about costs, cost-allocation, equivalent services, benefits, economies of scale, and disclosures, as they might impact fees. Any shareholder could expose those issues to judicial review, even if fund boards have addressed them, as occurred here. The hindsight assertion that they should have been resolved differently will always warrant review.

Similarly, petitioners' "fair process" prong would provoke a trial in nearly every case. Any perceived imperfection would suffice to trigger judicial review. In this case, for example, petitioners were unable to point to any *actual* failures of disclosure by Harris. Instead, petitioners claimed flaws in Harris's *method* of presenting certain information; their expert said he would have presented it differently. Petitioners then labeled Harris's methodology "false and misleading." J.A. 321-22, 329-30, 333. Petitioners' view of §36(b) would make any similar issue ripe for judicial reassessment.

The risks are obvious. No matter how an adviser presents information on any topic conceivably relevant to fees, a plaintiff could always propose either a different method or nitpick about how the information was used. See, *e.g.*, *Krinsk* v. *Fund Asset Mgmt., Inc.*, 875 F.2d 404, 409 (2d Cir. 1989) (district court did not err in refusing to measure performance on "risk-adjusted basis" because neither the SEC nor the industry had adopted that basis). Any claim that another approach was "better," or that independent directors should have applied the data differently in negotiations, would raise a disputed issue of fact. That consigns every mutual fund to a trial on a plaintiff's lawyer's whim.

This case illustrates the problem. Petitioners catalogued a litany of "issues" about the negotiations and the negotiators. Among other things, their shotgun approach claimed that social and business relations between trustees poisoned negotiations and that the board was dominated by a single member, who was "interested" based on compensation earned years before. But the district court's review of the undisputed record showed those allegations up as calumny. It concluded that the petitioners did not raise a triable issue of fact either to support

their allegations or to suggest that they contributed an adverse influence on the process. Pet. App. 31a-33a. The standard petitioners articulate now, however, would convert the ability to raise such issues to a right to put any investment adviser through a trial. That would force courts into an inappropriate role, with no anchor in the statutory text.

B. The Costs Of Petitioners' Proposed Standard Outweigh Its Slight Benefits

Petitioners' self-proclaimed role as investor champions ignores the cost their standard would impose.

Litigation is enormously expensive. Taking a suit from discovery through trial can easily cost tens of millions of dollars in attorneys' fees. The monetary cost is multiplied by the human costs, as the adviser, its officers, portfolio managers and fund board members produce documents, submit to depositions, and are distracted from their tasks. And the effective attack on board integrity that a fee suit represents inevitably raises a further impediment to attracting and retaining qualified board members. See generally *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 740 (1975) ("The very pendency of the lawsuit may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit.").

The real advantages to petitioners' standard are the benefits that accrue to lawyers. Because no individual shareholder could justify the cost of litigating fee and process "fairness" for the tiny, speculative personal benefit that might result, such claims, like securities class actions, pose "a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general," such that even frivolous cases may carry a high settlement value. *Blue Chip Stamps*, 421 U.S. at 739; see

also *Amron* v. *Morgan Stanley Inv. Advisers, Inc.*, 464 F.3d 338, 346 (2d Cir. 2006) (declining "to permit" a §36(b) "plaintiff 'with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of settlement value'" (quoting *Dura Pharms., Inc.* v. *Broudo*, 544 U.S. 336, 347 (2005), and *Blue Chip Stamps*, 421 U.S. at 741)).

III. THE COURTS BELOW CORRECTLY CONCLUDED THAT HARRIS DID NOT BREACH ITS FIDUCIARY DUTY "WITH RESPECT TO THE RECEIPT OF COMPENSATION"

The lower courts in this case correctly held that Harris did not breach its §36(b) fiduciary duty. The district court applied the *Gartenberg* standard. The Seventh Circuit "disapproved" *Gartenberg's* approach, but did not disturb the district court's key factual determinations. This Court should reject petitioners' proposed new standard and affirm the judgment.

A. The District Court Appropriately Applied *Gartenberg* To The Undisputed Facts

The district court applied the *Gartenberg* standard to the undisputed facts and concluded that Harris's fees were not "so disproportionately large that [they bore] no reasonable relationship to the services rendered." Pet. App. 35a (quoting 694 F.2d at 928). In urging otherwise, petitioners rely almost exclusively on the fees Harris charged its non-mutual fund clients. The district court found the comparison factually inapt because the undisputed record established that the "services Harris provided to institutional clients varied, but in all events *were more limited* than those they provided to the Funds." *Id.* at 16a (emphasis added); pp. 39-44, *supra*. Indeed, even if the services were "indistinguishable," the fee differen-

tial was insufficient to establish disproportionality. "[T]he amounts paid by different parties establish a range of prices that investors were willing to pay." Pet. App. 30a. "Harris's fees fell within [that] range." *Ibid.*

The *Gartenberg* "factors" all weigh against petitioners. "[T]he services rendered by [Harris]" were "of the highest quality." *Gartenberg*, 694 F.2d at 930. Indeed, while investors in *Gartenberg* received slightly "better-than-average return[s]," *id.* at 926, 930, the Oakmark Funds returned best-in-class performance during the relevant period, including results that were multiples of benchmark indices, pp. 9-10, *supra*. Petitioners "do not dispute that Harris's fees were comparable to those charged by other similar funds," Pet. App. 30a, another factor considered by *Gartenberg*, 694 F.2d at 927, 929.

The district court also recognized that the Funds' fee negotiation process was robust. The court had "no reason to discount the notion that the shareholders' interests were represented at the negotiating table by a group of people who were capable of giving those interests primacy." Pet. App. 31a. Harris's disclosures to the trustees were extensive, and greater than what would have been available to the prototypical arm's-length negotiator. Harris described its services, fees, and profits attributable to both the mutual funds and its institutional accounts. J.A. 146, 152-81. As in *Gartenberg*, the evidence demonstrated that "the trustees were aware of or could obtain the essential facts needed to negotiate a reasonable fee" and that the "non-affiliated Fund trustees * * * had considered extensive relevant information before [approving the fee]." 694 F.2d at 933; see Pet. App. 16a. As the district court emphasized, the bargaining process need not result in the "best possible arrangement"; it need only produce a result that, on its face,

could be the product of good-faith, arm's-length bargaining. Pet. App. 31a. The fees that Harris charged to the Funds met this standard and summary judgment was therefore appropriate. The court systematically and correctly rejected petitioners' myriad claims of process imperfections, finding they were either unsupported or had no effect on the board's conscientious execution of its fiduciary duty. *Id.* at 24a-26a.

B. The Court of Appeals Did Not Disturb The Factual Conclusions Of The District Court

The Seventh Circuit did not disturb the factual analysis of the district court. Like the district court, it recognized the lack of comparability with the services provided to the Funds' institutional clients. Pet. App. 13a. It also recognized that the fees Harris charged the Funds were comparable to those that "other funds of similar size and investment goals pay their advisers," "in both levels and breakpoints." *Id.* at 6a. Both courts found the trustee-review process to be robust, triggering substantial deference under §36(b)(2). The district court had "no reason to discount the notion that the shareholders' interests were represented at the negotiating table by a group of people who were capable of giving their interests primacy." *Id.* at 31a. The Seventh Circuit found no evidence that Harris "pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services." *Id.* at 14a.

While the Seventh Circuit disapproved of the *Gartenberg* approach, it did not alter the district court's legal or factual analysis. *Gartenberg*'s focus on fees that are "so disproportionate" that they could not have resulted from arm's-length bargaining, 694 F.2d at 928, is akin to the Seventh Circuit's discussion of fees that are "so unusual"

that they raise an inference of deceit. Pet. App. 9a. Although the Seventh Circuit used different language than the *Gartenberg* court to articulate the standard it applied, it looked to the same set of facts examined by the district court—the comparability of fees charged to similar mutual funds, the inapt comparisons to the fees charged to non-mutual fund clients, the robust trustee review and negotiation, and the lack of deceit or trickery on the part of Harris—in reaching the conclusion that Harris's fees did not violate §36(b). Indeed, *Gartenberg* and the Seventh Circuit's approach "lead to the same place." *In re Mut. Funds Inv. Litig.*, 590 F. Supp. 2d 741, 760 (D. Md. 2008). On the same undisputed facts, both the district court, applying *Gartenberg*, and the Seventh Circuit, applying its similar standard, concluded that Harris's fees were neither "so disproportionate" nor "so unusual" to support a conclusion of fiduciary breach.

There is no reason for this Court to revisit those fact-intensive conclusions or to remand for the court of appeals to conduct a redundant exercise. It is the "settled practice" of this Court to accept "factual determinations in which the district court and court of appeals have concurred." *Branti* v. *Finkel*, 445 U.S. 507, 512 n.6 (1980). This Court should not upset "concurrent findings of fact by two courts below in the absence of a very obvious and exceptional showing of error." *Exxon Co., U.S.A.* v. *Sofec, Inc.*, 517 U.S. 830, 841 (1996). None has been shown here.

CONCLUSION

For the foregoing reasons, the judgment of the Court of Appeals for the Seventh Circuit should be affirmed.

Respectfully submitted.

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AUGUST 2009

APPENDIX

RELEVANT STATUTORY PROVISIONS

Section 2 of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, provides in relevant part as follows:

§ 80a-2. Definitions; applicability; rulemaking considerations

(a) Definitions

When used in this subchapter, unless the context otherwise requires—

* * *

(19) "Interested person" of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at anytime since the beginning of the last two completed fiscal years of such company has acted as legal counsel for such company,

(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, engaged in any principal transactions with, or distributed shares for—

(I) the investment company;

(II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or

(III) any account over which the investment company's investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to—

(I) the investment company;

(II) any other investment company having the same investment adviser as such investment company or holding itself out to investors as a related company for purposes of investment or investor services; or

(III) any account for which the investment company's investment adviser has borrowing authority,[1]

(vii) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two completed fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same

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[1] So in original. Probably should be followed by the word "and".

investment adviser or principal underwriter or with the principal executive officer of such other investment company: *Provided*, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso; and

(B) when used with respect to an investment adviser of or principal underwriter for any investment company—

(i) any affiliated person of such investment adviser or principal underwriter,

(ii) any member of the immediate family of any natural person who is an affiliated person of such investment adviser or principal underwriter,

(iii) any person who knowingly has any direct or indirect beneficial interest in, or who is designated as trustee, executor, or guardian of any legal interest in, any security issued either by such investment adviser of principal underwriter or by a controlling person or such investment adviser or principal underwriter,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two completed fiscal years of such investment company has acted as legal counsel for such investment adviser or principal underwriter,

(v) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has executed any portfolio transactions for, en-

gaged in any principal transactions with, or distributed shares for—

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

(III) any account over which the investment adviser has brokerage placement discretion,

(vi) any person or any affiliated person of a person (other than a registered investment company) that, at any time during the 6-month period preceding the date of the determination of whether that person or affiliated person is an interested person, has loaned money or other property to—

(I) any investment company for which the investment adviser or principal underwriter serves as such;

(II) any investment company holding itself out to investors, for purposes of investment or investor services, as a company related to any investment company for which the investment adviser or principal underwriter serves as such; or

(III) any account for which the investment adviser has borrowing authority,[2]

(vii) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had at any time since

---

[2] So in original. Probably should be followed by the word "and".

the beginning of the last two completed fiscal years of such investment company a material business or professional relationship with such investment adviser or principal underwriter or with the principal executive officer or any controlling person of such investment adviser or principal underwriter.

For the purposes of this paragraph (19), "member of the immediate family" means any parent, spouse of a parent, child, spouse of a child, spouse, brother, or sister, and includes step and adoptive relationships. The Commission may modify or revoke any order issued under clause (vi) of subparagraph (A) or (B) of this paragraph whenever it finds that such order is no longer consistent with the facts. No order issued pursuant to clause (vi) of subparagraph (A) or (B) of this paragraph shall become effective until at least sixty days after the entry thereof, and no such order shall affect the status of any person for the purposes of this subchapter or for any other purpose for any period prior to the effective date of such order.

* * *

Section 10 of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, provides in relevant part as follows:

§ 80a-10. Affiliations or interest of directors, officers, and employees

(a) Interested persons of company who may serve on board of directors

No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

(b) Employment and use of directors, officers, etc., as regular broker, principal underwriter, or investment banker

No registered investment company shall—

(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an interested person, unless a majority of the board of directors of such registered company shall be persons who are not such principal underwriters or interested persons of any of such principal underwriters; or

(3) have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any invest-

ment banker. For the purposes of this paragraph, a person shall not be deemed an affiliated person of an investment banker solely by reason of the fact that he is an affiliated person of a company of the character described in section 80a-12(d)(3)(A) and (B) of this title.

(c) Officers, directors, or employees of one bank or bank holding company as majority of board of directors of company; exceptions

No registered investment company shall have a majority of its board of directors consisting of persons who are officers, directors, or employees of any one bank (together with its affiliates and subsidiaries) or any one bank holding company (together with its affiliates and subsidiaries) (as such terms are defined in section 1841 of title 12) or any one savings and loan holding company, together with its affiliates and subsidiaries (as such terms are defined in section 1467a of title 12), except that, if on March 15, 1940, any registered investment company had a majority of its directors consisting of persons who are directors, officers, or employees of any one bank, such company may continue to have the same percentage of its board of directors consisting of persons who are directors, officers, or employees of such bank.

(d) Exception to limitation of number of interested persons who may serve on board of directors

Notwithstanding subsections (a) and (b)(2) of this section, a registered investment company may have a board of directors all the members of which, except one, are interested persons of the investment adviser of such company, or are officers or employees of such company, if—

(1) such investment company is an open-end company;

(2) such investment adviser is registered under subchapter II of this chapter and is engaged principally in the business of rendering investment supervisory services as defined in subchapter II;

(3) no sales load is charged on securities issued by such investment company;

(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

(8) such investment company has only one class of securities outstanding, each unit of which has equal voting rights with every other unit.

(e) Death, disqualification, or resignation of directors as suspension of limitation provisions

If by reason of the death, disqualification, or bona fide resignation of any director or directors, the requirements of the foregoing provisions of this section or of section 80a-15(f)(1) of this title in respect of directors shall not be met by a registered investment company, the operation

of such provision shall be suspended as to such registered company—

(1) for a period of thirty days if the vacancy or vacancies may be filled by action of the board of directors;

(2) for a period of sixty days if a vote of stockholders is required to fill the vacancy or vacancies; or

(3) for such longer period as the Commission may prescribe, by rules and regulations upon its own motion or by order upon application, as not inconsistent with the protection of investors.

(f) Officer, director, etc., of company acting as principal underwriter of security acquired by company

No registered investment company shall knowingly purchase or otherwise acquire, during the existence of any underwriting or selling syndicate, any security (except a security of which such company is the issuer) a principal underwriter of which is an officer, director, member of an advisory board, investment adviser, or employee of such registered company, or is a person (other than a company of the character described in section 80a-12(d)(3)(A) and (B) of this title) of which any such officer, director, member of an advisory board, investment adviser, or employee is an affiliated person, unless in acquiring such security such registered company is itself acting as a principal underwriter for the issuer. The Commission, by rules and regulations upon its own motion or by order upon application, may conditionally or unconditionally exempt any transaction or classes of transactions from any of the provisions of this subsection, if and to the extent that such exemption is consistent with the protection of investors.

(g) Advisory boards; restrictions on membership

In the case of a registered investment company which has an advisory board, such board, as a distinct entity,

shall be subject to the same restrictions as to its membership as are imposed upon a board of directors by this section.

(h) Application of section to unincorporated registered management companies

In the case of a registered management company which is an unincorporated company not having a board of directors, the provisions of this section shall apply as follows:

(1) the provisions of subsection (a) of this section, as modified by subsection (e) of this section, shall apply to the board of directors of the depositor of such company;

(2) the provisions of subsections (b) and (c) of this section, as modified by subsection (e) of this section, shall apply to the board of directors of the depositor and of every investment adviser of such company; and

(3) the provisions of subsection (f) of this section shall apply to purchases and other acquisitions for the account of such company of securities a principal underwriter of which is the depositor or an investment adviser of such company, or an affiliated person of such depositor or investment adviser.

* * *

Section 15 of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, provides in relevant part as follows:

§ 80a-15. Contracts of advisers and underwriters

(a) Written contract to serve or act as investment adviser; contents

It shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, has been approved by the vote of a majority of the outstanding voting securities of such registered company, and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment.

(b) Written contract with company for sale by principal underwriter of security of which company is issuer; contents

It shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract—

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment.

(c) Approval of contract to undertake service as investment adviser or principal underwriter by majority of noninterested directors

In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a

registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

(d) Equivalent of vote of majority of outstanding voting securities in case of common-law trust

In the case of a common-law trust of the character described in section 80a-16(c) of this title, either written approval by holders of a majority of the outstanding shares of beneficial interest or the vote of a majority of such outstanding shares cast in person or by proxy at a meeting called for the purpose shall for the purposes of this section be deemed the equivalent of the vote of a majority of the outstanding voting securities, and the provisions of paragraph (42) of section 80a-2(a) of this title as to a majority shall be applicable to the vote cast at such a meeting.

(e) Exemption of advisory boards or members from provisions of this section

Nothing contained in this section shall be deemed to require or contemplate any action by an advisory board of any registered company or by any of the members of such a board.

(f) Receipt of benefits by investment adviser from sale of securities or other interest in such investment adviser resulting in assignment of investment advisory contract

(1) An investment adviser, or a corporate trustee performing the functions of an investment adviser, of a registered investment company or an affiliated person of such investment adviser or corporate trustee may receive any amount or benefit in connection with a sale

of securities of, or a sale of any other interest in, such investment adviser or corporate trustee which results in an assignment of an investment advisory contract with such company or the change in control of or identity of such corporate trustee, if—

(A) for a period of three years after the time of such action, at least 75 per centum of the members of the board of directors of such registered company or such corporate trustee (or successor thereto, by reorganization or otherwise) are not (i) interested persons of the investment adviser of such company or such corporate trustee, or (ii) interested persons of the predecessor investment adviser or such corporate trustee; and

(B) there is not imposed an unfair burden on such company as a result of such transaction or any express or implied terms, conditions, or understandings applicable thereto.

(2)(A) For the purpose of paragraph (1)(A) of this subsection, interested persons of a corporate trustee shall be determined in accordance with section 80a-2(a)(19)(B) of this title: *Provided*, That no person shall be deemed to be an interested person of a corporate trustee solely by reason of (i) his being a member of its board of directors or advisory board or (ii) his membership in the immediate family of any person specified in clause (i) of this subparagraph.

(B) For the purpose of paragraph (1)(B) of this subsection, an unfair burden on a registered investment company includes any arrangement, during the two-year period after the date on which any such transaction occurs, whereby the investment adviser or corporate trustee or predecessor or successor investment advisers or corporate trustee or any interested person of any such adviser or any such corporate trus-

tee receives or is entitled to receive any compensation directly or indirectly (i) from any person in connection with the purchase or sale of securities or other property to, from, or on behalf of such company, other than bona fide ordinary compensation as principal underwriter for such company, or (ii) from such company or its security holders for other than bona fide investment advisory or other services.

(3) If—

(A) an assignment of an investment advisory contract with a registered investment company results in a successor investment adviser to such company, or if there is a change in control of or identity of a corporate trustee of a registered investment company, and such adviser or trustee is then an investment adviser or corporate trustee with respect to other assets substantially greater in amount than the amount of assets of such company, or

(B) as a result of a merger of, or a sale of substantially all the assets by, a registered investment company with or to another registered investment company with assets substantially greater in amount, a transaction occurs which would be subject to paragraph (1)(A) of this subsection, such discrepancy in size of assets shall be considered by the Commission in determining whether or to what extent an application under section 80a-6(c) of this title for exemption from the provisions of paragraph (l)(A) of this subsection should be granted.

(4) Paragraph (l)(A) of this subsection shall not apply to a transaction in which a controlling block of outstanding voting securities of an investment adviser to a registered investment company or of a corporate trustee performing the functions of an investment adviser to a registered investment company is—

(A) distributed to the public and in which there is, in fact, no change in the identity of the persons who control such investment adviser or corporate trustee, or

(B) transferred to the investment adviser or the corporate trustee, or an affiliated person or persons of such investment adviser or corporate trustee, or is transferred from the investment adviser or corporate trustee to an affiliated person or persons of the investment adviser or corporate trustee: *Provided*, That (i) each transferee (other than such adviser or trustee) is a natural person and (ii) the transferees (other than such adviser or trustee) owned in the aggregate more than 25 per centum of such voting securities for a period of at least six months prior to such transfer.

* * *

Section 36 of the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.*, provides in relevant part as follows:

§ 80a-35. Breach of fiduciary duty

(a) Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

(b) Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of

liability; exempted transactions; jurisdiction; finding restriction

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payment received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loads for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78o of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

(c) Corporate or other trustees performing functions of investment advisers

For the purposes of subsections (a) and (b) of this section, the term "investment adviser" includes a corporate

or other trustee performing the functions of an investment adviser.

* * *

REPLY BRIEF

Supreme Court, U.S.
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No. 08-586

IN THE
Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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The Seventh Circuit devised a novel standard for assessing § 36(b) claims, which half that court rejected and neither Harris nor its industry *amici* defend in this Court.[1] Harris now advocates an approach it ascribes to *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), a case the Seventh Circuit "disapprove[d]." Pet. App. 8a. Because all parties agree the court below applied the wrong standard, at a minimum this Court must remand for further proceedings under the correct standard.

Under the proper test, an adviser violates § 36(b) when it fails to provide full and accurate disclosure of all material facts relating to its compensation or charges fees that are not fair to the fund. That standard flows directly from the well-settled meaning of "fiduciary duty," § 36(b)'s history, and this Court's cases, including *Pepper v. Litton*, 308 U.S. 295 (1939), and *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984). Pet. Br. 20-29; U.S. Br. 16-17.

Harris, by contrast, offers no discernible standard. It urges near-absolute deference to the "business judgment" of fund directors and relies on selected language from *Gartenberg* to argue that an adviser does not violate § 36(b) unless it charges a fee "so disproportionate[]" to the fees levied by advisers to similar mutual funds that it "could not have been" agreed to by parties bargaining at arm's length. Resp. Br. 28 (internal quotations omitted). That approach is unfaithful to the statutory text, § 36(b)'s history, and Congress's aims in restraining excesses among mutual fund investment advisers.

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[1] *Cf.* Br. in Opp. 30 ("[T]he Seventh Circuit's approach is clearly correct.").

Harris's reliance on policy arguments cannot obscure these critical facts:

- This case concerns the fees Harris charged the funds for *advisory services*, which are essentially the same in nature and cost as the services Harris provided to its independent clients. Pet. Br. 48-49 & n.47. The funds paid separate fees under separate agreements for *non*-advisory services. *Id.* at 49-50 & n.49.
- In percentage terms, Harris charged the funds, to which it owes a fiduciary duty, approximately twice as much for *advisory services* as it charged its independent clients, to which it owes no duty, for *advisory services*. *Id.* at 9-10.
- In dollar terms, Harris charged one of the funds *76 times* what it charged an independent client in an arm's-length transaction ($55 million compared to $720,000 for the independent client with a comparable investment objective). *Id.* at 10.[2]
- Harris's profit margins on advisory services were estimated to exceed 90% (excluding profit-sharing payments from costs). *Id.* at 11.
- The supposedly disinterested chair of the funds' board was a former Harris partner who received hundreds of thousands of dollars in deferred compensation from Harris annually. That deferred compensation was contingent on Harris's continued receipt of sufficient revenues, derived in large part from fees the board chair "negotiated" on the funds' behalf. *Id.* at 12, 39 n.29; JA74.

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[2] The disparity was 42 times between another fund and a comparable independent client. *See* Bogle Br. 29.

- Harris's partners received compensation of more than *six times* the industry average. JA413.

By any reasonable measure, those facts raise material issues regarding Harris's compliance with its fiduciary duty under § 36(b). Harris stands out in the industry for its rapacious appetite for income at its investor-beneficiaries' expense.

ARGUMENT

I. SECTION 36(b) REQUIRES FULL DISCLOSURE AND FAIR FEES

A. Section 36(b) Incorporates The Common-Law Fiduciary Duty Of Fairness And Full Disclosure

When Congress uses a term with a well-settled common-law meaning, it is presumed to incorporate that meaning into the statute. Pet. Br. 20. Although Harris concedes (at 27) that basic interpretive canon, it refuses to acknowledge that § 36(b)'s "fiduciary duty" incorporates the common-law principles that term embodies. Harris incorrectly asserts (at 27-36) that petitioners' test derives from special rules of trust law that Congress did not intend to incorporate in enacting § 36(b).

It has long been settled, however, that *all* fiduciaries, not just trustees, must provide full and accurate disclosure of all material facts and ensure that the transaction is fair to the one to whom the fiduciary duty is owed. *See, e.g.*, *Restatement (Second) of Trusts* § 2 cmt. b (1959) ("If the *fiduciary* enters into a transaction with the other and fails to make a full disclosure of all circumstances known to him affecting the transaction or if the transaction is unfair to the other, the transaction can be set aside

by the other.") (emphasis added). This Court has consistently applied those foundational principles of fiduciary-duty law outside the specific context of trusts. *See, e.g., SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963) (investment management); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921) (corporations).[3]

Pepper v. Litton confirms the universal applicability of the standard Congress adopted. As Harris admits (at 28), *Pepper* articulates the "essence of the test" as "whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." 308 U.S. at 306-07. But Harris ignores the immediately preceding sentence, in which this Court identified the "earmarks of an arm's length bargain." There, the Court explained that a fiduciary's dealings "are subjected to rigorous scrutiny" to determine (1) whether the fiduciary acted in "good faith," and (2) whether the transaction was "fair[] from the viewpoint of the" beneficiary. *Id.*

Moreover, *Pepper* – a corporate law case – drew for its two-part test for breach of fiduciary duty from the common law of trusts. *See id.* at 306 ("[Fiduciaries'] powers are powers in trust.") (citing *Jackson v. Ludeling*, 88 U.S. (21 Wall.) 616, 624 (1874)). As *Jackson* explained, "in a very legitimate sense," the officers of a company "h[o]ld" its property "as trustees." 88 U.S. (21 Wall.) at 624; *see also Varity Corp. v. Howe*, 516 U.S. 489, 502 (1996) (looking to "ordinary trust law understanding" because statute refer-

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[3] In *Manufacturers Trust Co. v. Becker*, 338 U.S. 304 (1949), which Harris cites (at 33), this Court abided by its "repeated[] insiste[nce] on good faith and fair dealing on the part of corporate fiduciaries." 338 U.S. at 310 (citing *Pepper*, 308 U.S. at 308-09).

enced "fiduciary"). Thus, *Pepper* and the authority on which it relied recognize that trust law is an especially influential source of fiduciary law, not a special body of law inapplicable in other contexts.

To be sure, Congress did not incorporate the common law wholesale in § 36(b). It placed the burden of proof on the plaintiff, for example, rather than on the fiduciary. *See* 15 U.S.C. § 80a-35(b)(1); Pet. Br. 24 n.17. But, contrary to Harris's assertion (at 28), Congress's adoption of a different approach to the burden of proof does not support the inference that it intended to alter the substance of what must be proved. Rather, Congress's action reflects an understanding of how the common law ordinarily operated and a choice to alter the burden of proof while leaving the substantive standard for a breach of fiduciary duty unchanged. *See* U.S. Br. 18.

B. Harris Concedes The Relevance Of Fees Charged To Independent Clients For Comparable Services

Harris's embrace of *Pepper* is important for an additional reason: it concedes the relevance of fees the adviser charges to independent clients for comparable services. According to Harris, the "fundamental consideration" and the "'essence of the test'" under § 36(b) is whether "'the transaction carries the earmarks of an arm's length bargain.'" Resp. Br. 28 (quoting *Pepper*, 308 U.S. at 306-07). The best way to make those determinations is to compare the transaction at issue to bargains produced by arm's-length negotiations. If an investment adviser's fees exceed materially those obtained in normal market transactions, then those fees do not "carr[y] the ear-

marks of an arm's-length bargain," and a violation of § 36(b) has occurred.[4]

Harris and its *amici* do not dispute that arm's-length transactions occur routinely in the marketplace for investment advisory services, particularly to independent institutional clients such as pension funds. If plaintiffs show that an adviser's fees compare poorly to the fees paid in such arm's-length transactions and that the services being provided by the adviser in the arm's-length transactions are comparable (even if not identical), then a court determines whether § 36(b) was violated by examining the aptness of the comparison and the materiality of any differences in services provided.

Harris's disagreement (at 40-43) that the services it provides to the funds and its independent clients are comparable is both incorrect (*see supra* p. 2; *infra* pp. 25-26; Pet. Br. 48-50) and a factual point to be evaluated on remand under the correct legal standard. The district court below rejected the independent-client comparison as a matter of law, *see* Pet. App. 30a, and the court of appeals dismissed it without citing record evidence, *see id.* at 39a, 41a (Posner, J.). Thus, neither court below evaluated the comparability of the services here under the correct legal test.

C. Harris's Version Of *Gartenberg* Finds No Support In § 36(b)'s Text

Harris offers no textual or historical support for its assertion that § 36(b) imposes liability only for fees that are "so disproportionately large" that they "'could not have been the product of arm's-length

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[4] *Cf. Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988) (defining "materiality" in the securities context).

bargaining.'" Resp. Br. 28 (quoting *Gartenberg*, 694 F.2d at 928). It repeatedly invokes *Gartenberg*, but that case offered inconsistent standards: the "so disproportionate[]" formulation (without any authority), and another one that more accurately captures the common-law fiduciary duty § 36(b) embodies – "whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all the surrounding circumstances," 694 F.2d at 928. This Court's task, of course, is not to parse *Gartenberg*'s unexplained deviation from common-law principles when it used the "so disproportionate[]" language, but to construe § 36(b) as Congress wrote it. There is no basis elsewhere in the law to excuse a fiduciary's breach merely because it represents a somewhat less than "so disproportionate[]" departure from the fiduciary's legal obligations. The law of fiduciary duty rejects Harris's proffered approach. *See, e.g.*, *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928); Pet. Br. 21-24.

Further, nothing in § 36(b)'s text or history suggests that Congress intended that an investor must meet the extraordinary burden of proving a negative – that the fees *could not have been* the product of an arm's-length bargain. By reversing the burden of proof from common-law breach-of-fiduciary actions, Congress evinced no intent to change the underlying substantive standard, which requires the shareholder to prove that the compensation is not comparable to what would have been agreed to in an arm's-length transaction (not that no arm's-length negotiation could have produced the fees). Evidence that the adviser charges much lower fees to other, independent clients with whom it bargains at arm's length is highly probative on that question.

In addition, Harris's repeated assertion that enforcing § 36(b) will lead inexorably to "judicial rate regulation" (at 38) does not withstand scrutiny. Under a traditional scheme of rate regulation, the regulated entity is limited to recovering its costs and obtaining a "fair return" on invested capital – nothing more – and a regulatory agency polices the entity's rates to ensure compliance. *See generally Verizon Communications Inc. v. FCC*, 535 U.S. 467, 481-86 (2002).

Courts adjudicating claims of breach of fiduciary duty engage in a fundamentally different analysis. They evaluate "all the circumstances"[5] to determine whether "the transaction carries the earmarks of an arm's length bargain." *Pepper*, 308 U.S. at 306-07. Performing that traditional inquiry does not involve courts in the type of cost-based judicial ratemaking that Congress sought to avoid in imposing a fiduciary duty on investment advisers. Put differently, a court need not set a fee; it need only determine that the fee charged violates the adviser's fiduciary duty. Certainly, Harris's practice of charging captive funds twice in percentage terms what it charges independent clients – which supports a 90% profit margin and partner compensation at six times the industry average (*supra* p. 2) – should flunk any reasonable assessment of fiduciary duty without entangling federal judges in fee setting. Indeed, when evidence of what the adviser charges in arm's-length transactions for comparable services is available, courts can compare those market prices to the prices the adviser charges its captive funds without undertaking any

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[5] *Pepper*, 308 U.S. at 306; Resp. Br. 28; *accord* S. Rep. No. 91-184, at 15 (1969) ("all the facts"); *Gartenberg*, 694 F.2d at 928 ("all of the surrounding circumstances").

analysis of the adviser's costs or appropriate rate of return.

D. The History Of § 36(b) Confirms The Statute's Plain Meaning

The origin of § 36(b)'s fiduciary duty is undisputed. *See, e.g.*, Pet. Br. 44-48; U.S. Br. 19-20; Bogle Br. 16-18. After an initial version of the 1970 Amendments imposing a "reasonableness" standard on investment advisers failed to pass the House, the SEC and the Investment Company Institute ("ICI"), the entity representing investment companies and advisers, separately submitted to the House explanations of the proposed "fiduciary duty" standard ultimately enacted in § 36(b). *See* 1969 Hearings[6] 187 (SEC Memorandum), 441 (ICI Letter); *see also* Bogle Br. Apps. B-C. The SEC and ICI agreed that (1) the "fiduciary duty" standard derived from the common law and required full disclosure and substantive fairness, Pet. Br. 47 & nn.44-45; (2) the "fiduciary duty" standard differed from the "reasonableness" standard procedurally, *id.* at 45-47; and (3) the switch to "fiduciary duty" eliminated concerns that the "reasonableness" standard could subject fund *directors* to suit and could be misconstrued as authorizing cost-based rate regulation, *id.* at 46 & nn.41-42. There is no evidence that Congress intended to relieve *investment advisers* of the requirements of fairness and disclosure inherent in their fiduciary duty to investors.

Harris emphasizes (at 36-37) that Congress changed the amendment's wording from "reason-

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[6] *Mutual Fund Amendments (Part 1): Hearings Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. (1969) ("1969 Hearings").

ableness" to "fiduciary duty," but Harris provides no response to the reasons why Congress did so. That legislative history undermines Harris's claim that Congress intended a much more limited standard in revising the proposed language. *See* 1969 Hearings 189 (SEC Memorandum) ("The short answer to the question posed by Chairman Moss then is that there is little substantive difference between the standard of reasonableness and the standard of breach of fiduciary duty."), 441 (ICI Letter) (adviser "may not overreach in the amount of his fee even though the other party to the transaction, in full possession of all the facts, does not believe the fee is excessive").[7] *Gartenberg* recognized as much, concluding that "the substitution of the term 'fiduciary duty' for 'reasonable'" was "a more semantical than substantive compromise." 694 F.2d at 928; *see also Daily Income Fund*, 464 U.S. at 534 n.10 (Congress enacted § 36(b) because it believed existing law inadequate "to ensure reasonable adviser fees"). Thus, § 36(b)'s history lends no support to Harris's cramped construction of that provision.

E. The ICA's Structure Confirms Congress Intended § 36(b) To Be An Independent Check On Excessive Fees And Unscrupulous Negotiations

1. Harris contends (at 34) that the normal principle of incorporating meaning to Congress's use of a

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[7] Harris incorrectly implies (at 36) that this Court in *Burks v. Lasker*, 441 U.S. 471, 483 (1979), identified "reasonableness review" as one of the "more drastic remedies" Congress rejected in the 1970 Amendments. In fact, the *Burks* Court listed remedies "such as complete disaffiliation of the companies from their advisors or compulsory internalization of the management function," *id.* – not so-called "reasonableness review."

common-law term like "fiduciary duty" should be ignored because, "[i]f Congress had intended to incorporate a specific trust-law standard, it could have required investment adviser compensation to be 'fair' or 'reasonable,'" as it did in "*other* provisions of the ICA." That argument proves too much. Any time Congress relies on a common-law term, it could have used more specific language to convey its intent. Congress employs common-law terms to invoke a body of law associated with them, rather than an unfamiliar phrase that could be misconstrued if interpreted outside the context Congress intends. *See, e.g., Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 323 (1992) (inferring intent to incorporate common-law meaning of "employee" in the Employee Retirement Income Security Act of 1974).

More fundamentally, language requiring "fair and reasonable" adviser fees would not have achieved all Congress intended. While it would have established a standard for evaluating the size of adviser fees, it would not have required full and accurate disclosure of all material facts relating to fees. Congress instead imposed on advisers a fiduciary duty, which incorporates both the obligation of full disclosure and the requirement of substantive fairness.

Harris's effort (at 34-35) to find support for its interpretation through citation to other provisions using reasonableness language ignores the different contexts in which those provisions operate. For example, ICA § 17(b)(1), which requires transactions between an affiliate of an investment company and the company to be "reasonable and fair," 15 U.S.C. § 80a-17(b)(1), is administered by the *SEC* in the first instance, not courts, *see id.* § 80a-17(b). Congress wanted the SEC, "an agency with great experi-

ence in the industry," to apply the criteria of fairness and reasonableness "to particular business situations in a manner consistent with the legislative intent." *E.I. du Pont de Nemours & Co. v. Collins*, 432 U.S. 46, 54 (1977). In contrast, when Congress sought to subject investment advisers to judicial (as opposed to regulatory) oversight, Congress used a familiar term – "fiduciary duty" – that courts historically have applied.

2. Harris and its *amici* misunderstand the role of fund boards of directors in Congress's design for § 36(b) actions. They assert that a "so disproportionate[]" standard properly "captures the deference that federal courts owe to the business judgment of the board." Resp. Br. 29-30, 35-36. Harris's proposal for unconstrained deference to fund boards, whose members are hand-picked by advisers, *see, e.g.*, JA122-23, finds no support in § 36(b)'s text or history or this Court's cases. Rather, Harris's deference claim, which would allow advisers to take as much as they can get so long as they obtain board approval, runs directly counter to Congress's purpose in enacting § 36(b) and would reintroduce the "waste" standard that Congress rejected.

When Congress amended the ICA in 1970, it "decided not to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board." *Daily Income Fund*, 464 U.S. at 540; *accord Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991). Instead, Congress intended fund directors and § 36(b) suits to function as "*independent* checks on excessive fees." *Daily Income Fund*, 464 U.S. at 541 (emphasis added). As the Solicitor General and the SEC have explained, § 36(b) "reflects a congressional determi-

nation that, due to conflicts of interest in assessing the fairness of compensation paid to a company's investment adviser, courts cannot defer to the business decisions of investment company directors." SEC Br. at 9, *Daily Income Fund*, *supra* (No. 82-1200). Thus, the role of fund boards in policing adviser compensation (albeit important to the statutory scheme) provides no basis for weakening § 36(b)'s independent right of action for injured shareholders.

Harris claims (at 30) that fund boards "negotiate from a position that is *better* than arm's-length" through receipt of ICA-required disclosures from investment advisers. That argument strains credulity on this record. Harris provided the funds' board with inaccurate and misleading information regarding (among other things) the comparability of services provided to its independent clients, Pet. Br. 11-12, 52, in "negotiating" a fee 76 times more in dollar terms than the fee it negotiated in an actual arm's-length transaction with an independent client (*see supra* p. 2). Harris and its *amici*'s assumption that advisers always provide complete and accurate information regarding their compensation is false and cannot support the standard they propose.

More fundamentally, § 36(b) is based on skepticism that even a properly informed fund board can engage in true arm's-length bargaining with the adviser. The board lacks the critical tool of an arm's-length negotiator – the ability to walk away from the negotiations and deal with someone else instead. *See Burks*, 441 U.S. at 481 ("'[A] mutual fund cannot, as a practical matter[,] sever its relationship with the

adviser.'") (quoting S. Rep. 91-184, at 5).[8] That structural defect in the typical mutual fund-adviser relationship necessitates § 36(b) as an independent check on adviser compensation.

Harris pins much of its deference claim on § 36(b)(2). But Harris's argument contradicts the statutory language, which does not use the word "deference" and instead provides that board approval of adviser compensation "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). That language *frees* courts from being bound by what fund boards have approved; it does not command judicial *deference* to that approval. As this Court has recognized, Congress intended § 36(b)(2) to reverse the former "waste" standard, which was highly deferential to fund boards, and to establish § 36(b) as an "independent check[] on excessive fees." *Daily Income Fund*, 464 U.S. at 534 n.10, 540 n.12, 541. Thus, the point of Congress instructing courts to give board approval only such consideration "as is deemed appropriate under all the circumstances," 15 U.S.C. § 80a-35(b)(2), was to *reject* deference in favor of a standard making board review one circumstance among many to be considered. Harris offers no support for the incongruous notion that Congress created an independent check on fund directors' decisions to approve adviser compensation but commanded courts to abdi-

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[8] *See also Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337, at 12 (1966) (with the typical captive mutual fund, "the essential element of arm's length bargaining – the freedom to terminate negotiations and to bargain with other parties – is lacking").

cate their normal function by giving "deference" to those decisions.[9]

F. The ICA Requires "Fair Process" As Part Of The Adviser's Fiduciary Duty

In the starkest example of its abandonment of the decision below and the position advanced in its brief in opposition, Harris now claims (at 44) that § 36(b)'s fiduciary duty "does not extend to the process of disclosure and negotiation by which fees are approved."[10] Harris bases its excessive-fees-only rule on § 36(b)'s language providing that the adviser's fiduciary duty applies "with respect to the receipt of compensation." 15 U.S.C. § 80a-35(b). But Harris fails to explain why an adviser's provision of information about and negotiations regarding its *compensation* lie beyond the scope of that fiduciary duty. Nor could it. As this Court has concluded, the phrase "with respect to" quite broadly encompasses the subjects in issue. *See Riegel v. Medtronic, Inc.*, 128 S. Ct. 999, 1010 (2008)

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[9] Harris's *amici* argue that review of a fund board's approval of adviser compensation should be "highly deferential." Ind. Dir. Br. 24; *see also* Fidelity Br. 8. But, to give § 36(b) some function, they must concede that "little or no deference may be due when the directors' approval was a mere formality." Ind. Dir. Br. 3. That concession is decisive. Even judicial review for the "mere formality" of a board's action must extend beyond ascertaining whether the board received the requisite information and then voted favorably on the contract. A price charged to the fund that is materially greater than the fee charged in comparable arm's-length transactions for investment advisory services gives great reason to doubt that board approval was more than a "mere formality." (At a minimum, a court would have to find that the board received complete and accurate information and suffered from no conflicts of interest before it could give the board's approval significant consideration.)

[10] *Cf.* Br. in Opp. 30 ("An adviser can breach its fiduciary duty, for example, through lack of candor in negotiation.").

(rejecting argument that a statute preempting requirements "with respect to a device" was inapplicable unless the requirement in question applied "*only* to the relevant device, or only to medical devices and not to all products and all actions in general").

Indeed, Harris's newfound argument cannot be squared with the ICI's contemporaneous explanation to Congress in 1969 of its understanding of § 36(b)'s fiduciary duty. The ICI then stated that the "receipt of compensation" language was included to make clear that "the adviser or other person who received the compensation" – and not fund board members or other "non-recipients" – may be sued under § 36(b). 1969 Hearings 440-41; *accord id.* at 189 (SEC Memorandum). Thus, the "receipt of compensation" language was intended to identify the correct *defendant*, not to limit the fiduciary duty. Nothing suggests that Congress employed the "receipt of compensation" language in § 36(b) to depart from the common-law meaning of "fiduciary duty."

Nor can Harris find support in Congress's decision to limit recovery under § 36(b) to "actual damages." 15 U.S.C. § 80a-35(b)(3). That restriction on the *remedies* available for a violation of § 36(b)'s fiduciary duty does not create a limitation on the duty itself. A plaintiff need not have suffered "actual damages" to have a valid cause of action under § 36(b). Indeed, § 36(b)(3) expressly contemplates that plaintiffs will seek "other relief," such as an injunction or rescission of the adviser's contract. *Id.* § 80a-35(b)(3); *see id.* § 80a-46(b) (rescission). The district court in this case recognized as much in rejecting Harris's argument that petitioners' request for rescission should be stricken, explaining that § 36(b)(3)'s reference to "damages or other relief," *id.* § 80a-35(b)(3), "refutes

Harris's contention that the only remedy to be had is monetary." JA27; *see* Pet. Br. 8-9.

In addition, Harris argues (at 45) that the existence of ICA § 15(c) shows that the disclosure-and-negotiation process must be beyond the scope of § 36(b). Section 15(c) requires that a majority of disinterested fund directors approve the adviser's contract with the fund and obligates advisers to furnish information necessary to facilitate the fund board's review of that contract. *See* 15 U.S.C. § 80a-15(c). Even assuming that the fair-process prong of the § 36(b) fiduciary duty requires no more than what § 15(c) requires,[11] § 36(b)'s process-oriented obligations are not superfluous. Section 36(b) provides "new enforcement mechanisms" (U.S. Br. 14-15), including a damages remedy for shareholders injured by an adviser's failure to provide full disclosure or to negotiate fairly. Although Congress might have achieved a similar result by providing an explicit right of action for violations of § 15(c), that alone would not have

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[11] That assumption is dubious, because § 36(b)'s fiduciary duty requires more than just the provision of information; it also imposes an affirmative obligation to negotiate in good faith. *See, e.g., Capital Gains Research Bureau*, 375 U.S. at 194 (a fiduciary has "an affirmative obligation to employ reasonable care to avoid misleading his clients") (internal quotations and footnote omitted); 1969 Hearings 441 (ICI Letter) ("In addition to considering the adviser's conduct the court would focus on the substance and quality of the negotiations which led to the contract in determining whether the adviser had breached his fiduciary obligations."); IIA Austin W. Scott & William F. Fratcher, *The Law of Trusts* § 170.25, at 436 (4th ed. 1987) (a trustee may "take[] no advantage of his position" in negotiating with a beneficiary); George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 544, at 493 (rev. 2d ed. 1993) (fiduciary owes a duty of "fair play in the direct dealing with his principal").

fulfilled Congress's full purpose. Section 36(b) requires both fair process and fair result, and the statute provides a cause of action for violating either requirement. Creating an express right of action for violation of § 15(c) would not have accomplished Congress's goal of empowering investors to redress excessive adviser fees.

Finally, Harris argues (at 46) that "adviser misconduct unrelated to a fee" can be addressed by the SEC under ICA § 36(a), 15 U.S.C. § 80a-35(a). That assertion is off point because the § 36(b) fair-process prong does not apply to matters "unrelated to a fee." Instead, it requires full disclosure of material facts *relating to the adviser's fees* and fair negotiation *regarding those fees*. In any event, § 36(a) and § 36(b) fulfill complementary, not duplicative, functions. The fiduciary duty of § 36(a) is enforceable only by the SEC, is not limited to the receipt of compensation, and is imposed on officers, directors, and advisers alike; further, a breach requires "personal misconduct." *Id.* In contrast, § 36(b) is privately enforceable, is limited to the receipt of compensation, and is imposed only on the recipient of compensation, *id.* § 80a-35(b); further, a breach does not require proof "that any defendant engaged in personal misconduct," *id.* § 80a-35(b)(1).[12]

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[12] Harris claims (at 48) that no case before *Gallus v. Ameriprise Financial, Inc.*, 561 F.3d 816 (8th Cir. 2009), had recognized the adviser's duty to provide full disclosure and negotiate in good faith, but it ignores *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976), on which the Eighth Circuit relied, *see Gallus*, 561 F.3d at 823 n.3; Pet. Br. 24-25.

II. HARRIS'S POLICY ARGUMENTS LACK MERIT

A. Post-Enactment Developments Support The Need For Sound Enforcement Of § 36(b)

1. In an effort to convince this Court that the protections of § 36(b) are no longer necessary, Harris and its *amici* assert that "average expenses for stock funds declined from 2.32% of assets in 1980 to 0.99% in 2008." Resp. Br. 7; *see* ICI Br. 30-31; SIFMA Br. 5; Chamber of Commerce Br. 21; Fidelity Br. 22. That argument cannot affect this Court's interpretation of Congress's intent in enacting § 36(b), which by its terms provides a check on each adviser's compensation, regardless of whether total expenses industry-wide are increasing or decreasing. *See* Pet. Br. 42; U.S. Br. 29.

In any event, the actual industry-wide trend has been toward ever-increasing costs, both in percentage terms and in dollar amount. Based on Harris's own statistics (at 7), total industry costs in 1980 were approximately *$16.6 million* (*i.e.*, total assets of $715 million times costs of 2.32%), while total industry costs in 2008 had risen to *$95 billion* (*i.e.*, $9.6 trillion times 0.99%). Yet Congress enacted § 36(b) to address the failure of funds to account for the huge fees that resulted from applying a constant (or relatively constant) percentage fee to an ever-increasing asset base. *See Daily Income Fund*, 464 U.S. at 537; S. Rep. 91-184, at 4, 6. No one believes that managing a $5 billion portfolio of stocks costs 10 times as much as managing a $500 million portfolio with the same investment objectives.

Even taking Harris's assertion at face value – that percentages, not dollars, are what matter – the

industry's self-serving calculations are misleading. A large proportion of the supposed decline in total costs under the industry's figures stems from the massive growth since 1980 in index funds.[13] Index funds require little investment advice and operate at low cost. By including them in the overall statistics, Harris and its *amici* cloak that *actively managed* equity funds of the sort at issue here have been charging steadily higher fees to their clients. Properly calculated, total costs of equity funds as a percent of assets have increased, not decreased, over the last 30 years.[14]

Further, Harris's statistics are suspect because they represent *total* fund costs. This case involves only investment *advisory* fees, not any other components of total-investment expenses, such as sales loads or administrative expenses. Thus, for example, the figures cited by Harris and its *amici* include sales loads, which have declined significantly over the years but have nothing to do with the trend in investment advisory fees.[15]

2. Harris erroneously claims (at 38) that the "mutual fund market" has become "extraordinarily competitive." But, in making that assertion, Harris focuses on the wrong market. Neither Harris nor its

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[13] *See, e.g., Mutual Fund Industry Practices and Their Effect on Individual Investors: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 81, 118-19 (2003) (testimony of John Bogle).

[14] *See, e.g., id.* at 79 (expense ratio of average equity fund increased from 0.98% in 1978 to 1.61% in 2002).

[15] *See, e.g., id.* at 81, 118-19. A sales load is a one-time charge of a certain percentage of assets usually assessed when the investor purchases a mutual fund.

amici dispute that, for the typical captive mutual fund, there is no "market" for investment advice; the captive fund will always be run by the adviser that created it, and neither investors nor the board have any practical ability to change that adviser.

Harris instead claims that competition among funds for investors constrains adviser fees. Substantial economic evidence rebuts that contention, however. *See, e.g.*, Pet. App. 37a-38a (Posner, J.) (Harris's "economic analysis" is "ripe for reexamination"); *Gallus*, 561 F.3d at 820 (citing six studies concluding that "inherent conflicts of interest and a lack of meaningful competition between mutual funds have led to systematic overpricing of investment advice"); Litan Br. 7-15 (arguing that market forces cannot constrain mutual fund fees to competitive levels). Moreover, Harris offers no response to petitioners' explanation of the practical constraints on investors' ability to avoid high-priced funds and the contemporary insights from behavioral economics regarding investors' decision-making. Pet. Br. 42-43. Finally, Harris does not dispute the impact that investors' brokers – who have been known to receive from advisers referral fees paid out of fund assets unbeknownst to fund shareholders (or even fund boards) – have on investors' fund choices. *Id.* at 44; *see, e.g., In re Franklin Advisers, Inc. and Franklin/Templeton Distributors, Inc.*, Investment Advisers Act Rel. No. 2337 (Dec. 13, 2004).[16]

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[16] The industry claims that the lack of competition among advisers for fund business does not matter because fund complexes compete for shareholders' business. That argument, however, undermines its separate assertion that courts should defer to fund directors' business judgment. If the only alleged competitive constraint comes from investors, then there is no

B. Harris Exaggerates The Litigation Effects Of Implementing Congress's Intent

To distract the Court from its unsound interpretation of § 36(b), Harris complains (at 49-52) – without empirical support – that interpreting § 36(b) as Congress intended would impose an undue burden on investment advisers without benefiting investors. But Harris's complaints about the expense and burdens of litigation should be addressed to Congress, which made the policy decision to subject investment advisers to shareholder suits under § 36(b).

In fact, Congress addressed the types of fears raised by Harris in enacting § 36(b). It armed investment advisers with a number of litigation weapons to thwart frivolous suits under § 36(b), such as shifting the burden of proof to the plaintiff, *see* 15 U.S.C. § 80a-35(b)(1); limiting the damages period and the amount of damages recoverable, *see id.* § 80a-35(b)(3); and requiring suits to be brought in federal court, *see id.* § 80a-35(b)(5).

Harris contends that those protections are inadequate and asserts (at 49-50) that a common-law fiduciary-duty standard will require a trial in every case. But courts applying the common law regularly dismiss breach-of-fiduciary-duty claims on the pleadings.[17] Further, Harris offers the unfounded worry

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reason to believe that fund boards serve the bargaining function that Harris and its *amici* attribute to those boards. Instead, the adviser will take as much as it can get from the fund, constrained only by the supposed concern that high fees – which often are difficult for even knowledgeable investors to ferret out – will drive away investors.

[17] *E.g.*, *Covinsky v. Hannah Marine Corp.*, 903 N.E.2d 422, 432 (Ill. App. Ct. 2009); *Desimone v. Barrows*, 924 A.2d 908, 948-50 (Del. Ch. 2007); *Robinson v. Midlane Club, Inc.*, No. 94-C-1459, 1995 WL 453057, at *3-*6 (N.D. Ill. July 28, 1995).

that a plaintiff or expert "could quibble" with the adviser's fees or "nitpick about how the information was used" (*id.*) and thereby force a trial. Quibbling and nitpicking do not entitle a plaintiff to a trial under the common law or otherwise. Instead, a plaintiff must produce evidence creating *genuine* issues of material fact. *See* Fed. R. Civ. P. 56(c)(2); *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-27 (1986). Federal courts have ample tools to weed out meritless claims under § 36(b).

Equally unpersuasive is Harris's complaint (at 51) that "no individual shareholder could justify the cost of litigating fee and process 'fairness' for the tiny, speculative personal benefit that might result," and that lawyers are the true beneficiaries of § 36(b). To the contrary, fund shareholders are the beneficiaries of § 36(b); § 36(b) suits are brought derivatively "on behalf of" a mutual fund, and all shareholders benefit from any damages (or other relief) obtained in the action. 15 U.S.C. § 80a-35(b). For example, a prospective reduction in the adviser's fee schedule can amount to tens of millions of dollars in annual fee savings for the funds, Pet. Br. 10, and can make a substantial difference in returns for individual investors.[18] Thus, what Harris dismissively characterizes (at 49) as "grains off a penny" amount to a real stake for the funds and its shareholders – not to mention millions of dollars of its beneficiaries' money in profits to Harris.

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[18] *See, e.g.*, Pet. Br. 43 n.32; U.S. Dep't of Labor, Employee Benefits Security Administration, *A Look at 401(k) Plan Fees* 2 ("[A] 1 percent difference in fees and expenses would reduce your account balance [after 35 years] by 28 percent."), http://www.dol.gov/ebsa/pdf/401kFeesEmployee.pdf.

III. PETITIONERS' EVIDENCE WARRANTS A TRIAL ON THE MERITS

Because Harris does not defend the Seventh Circuit's reasoning, this case at a minimum should be remanded for further proceedings under the correct standard. Harris seeks (at 52-55) to avoid that result, relying on the district court's supposed application of *Gartenberg*. That argument is unavailing because, like the court of appeals, the district court applied an incorrect legal standard.

A. The District Court Made No "Findings"

Harris repeatedly claims that the district court "found" from an "undisputed" record that Harris's services to its independent clients were "'more limited'" than services provided to the funds. *E.g.*, Resp. Br. 52 (quoting Pet. App. 16a). But the court's "more limited" reference was in the background section of its opinion, *see* Pet. App. 16a, and was not a "finding" comparing services.[19] In fact, the district court dismissed the independent-client comparison as a matter of law. It held that the "range" of permissible fees "extended from a low-end figure below what the institutional clients were paying and a high-end figure beyond the fees that other mutual fund clients paid." *Id.* at 30a. The test, however, is not whether fees fall within the range of all fees charged to all

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[19] To the extent the district court intended its brief background statement to constitute a "finding" that differences in services explain the fee disparity, the court's action impermissibly resolved a genuine evidentiary dispute on summary judgment. *See Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986) ("[A]t the summary judgment stage the judge's function is not himself to weigh the evidence and determine the truth of the matter but to determine whether there is a genuine issue for trial.").

other customers. Indeed, every fee but the highest will fall within that range, rendering the test self-fulfilling. *See Gallus*, 561 F.3d at 823; *Gartenberg*, 694 F.2d at 929. Where, as here, the evidence shows that independent clients who bargain at arm's length with Harris receive comparable services at materially lower fees, at a minimum there is a genuine issue of material fact regarding the fees' fairness.

Harris lists various services purportedly offered to the funds but not independent clients.[20] But Harris fails to acknowledge that the funds pay separate fees for those additional services under agreements that are separate from the funds' "investment advisory" agreements with Harris, which provide only for actual investment advisory services. JA352 (¶ 19), 529-31. For instance, a separate "administration agreement," JA558, covers, among other things, preparation of financial information for the funds' management, board, and shareholders; portfolio compliance monitoring; and preparation of tax forms.[21] The funds also have a separate "transfer agency and service agreement" that covers shareholder services, including shareholder communications, among a host of other services. JA542, 551-55. For the other categories that Harris mentions (at 40-41) – "oversight of third-party vendors" and regulatory compliance – Harris makes no effort to explain these services or to quantify or justify its costs in light of the huge

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[20] *See* Resp. Br. 40 (listing, *e.g.*, "administrative services," "shareholder communications, including the preparation and distribution of prospectuses and periodic reports," "trustee support, including preparation of materials for board meetings," and "tax administration").

[21] *See* Administration Agreement, App. B (Exh. C-38 to Plaintiffs' Statement of Additional Facts (Oct. 10, 2006)).

disparity in fees charged. Indeed, petitioners' experts demonstrated that the cost of any supposed additional services provided by Harris is negligible compared to the difference in fees, JA354-55 (¶ 22), 432-33, and that it actually costs Harris *more* to serve its institutional clients than its funds, JA354-55 (¶ 22), 431-34, 493-96.

B. Supposed Performance Does Not Justify Harris's Fees

Harris unpersuasively attempts (at 53) to justify its compensation through performance. First, fund performance casts little light on whether an adviser is fulfilling its fiduciary obligation where, as here, the advisory fee is not explicitly tied to investment results and the same fee applies no matter how the fund performs. Second, virtually all of Harris's evidence predates the relevant damages period in this case, which began on August 17, 2003. *See* Pet. App. 17a n.2; JA335. Since then, the funds' performance has declined. Pet. Br. 51. And, even at its best performance, Harris cannot justify charging the captive funds *76 times* in dollar terms what Harris charged independent clients.[22]

C. Fee "Negotiations" Were Not "Robust"

Harris also rests (at 53) on the "fee negotiation process." But Harris notably does not dispute that the funds' board chair – and a designated disinterested trustee – Victor Morgenstern was a former

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[22] The claim by Harris's *amici* that Harris did not "increase the advisory fee rates for any of these funds" (SIFMA Br. 7) is a semantic deflection. Fund assets grew so substantially over time that, even by keeping rates the same, Harris reaped dramatic increases in fees – an increase of more than $45 million in one year alone. *See* Pet. Br. 11; *see also Daily Income Fund*, 464 U.S. at 537.

Harris partner who remained *interested in Harris* within the meaning of the ICA. Pet. Br. 39 & n.29. The lower courts dismissed that fact as irrelevant, noting that Harris's compensation was approved by a majority of disinterested trustees even if Morgenstern's vote were excluded. *See* Pet. App. 3a, 25a. But the lower courts refused to examine Morgenstern's influence over the negotiation process. *See id.* at 4a. His status and role belie Harris's claim (at 53) that the process was "robust," particularly when combined with petitioners' other evidence of conflicts among Harris and the board and Harris's failure to disclose those conflicts (not to mention Harris's failure to provide the board with complete and accurate information). *See* Pet. Br. 11-13, 52; JA83, 364-68; *see also* Pet. App. 40a (Posner, J.) (the more connected the directors and management, the higher the fees that go to management).[23]

D. Harris Abandons The Seventh Circuit

Neither Harris nor its industry *amici* attempt to defend the Seventh Circuit's analysis. Instead, Harris asserts (at 54) that the Seventh Circuit did not disturb the "factual analysis" of the district court. But the district court did not make (and could not have made) findings on summary judgment that the court of appeals could leave undisturbed. And, as

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[23] The district court made no finding that the process *in fact* functioned properly; instead, it said only that it had "*no reason to discount* ***the notion*** that the shareholders' interests were represented at the negotiating table by a group of people who were *capable* of giving those interests primacy." Pet. App. 31a (emphases added). Indeed, Harris identifies nothing in the record (*e.g.*, minutes of a board meeting) suggesting that the funds' board actually discussed and approved paying Harris 76 times what an independent client paid for comparable services.

Judge Posner recognized, the Seventh Circuit's discussion of factual issues in this case amounted to nothing more than "suggestions" and "airy speculation" with no "evidentiary or empirical basis." Pet. App. 39a, 41a (Posner, J.).[24]

CONCLUSION

The judgment of the court of appeals should be reversed and the case remanded.

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[24] This Court's practice of accepting "factual determinations" of lower courts does not apply to review of summary judgment; it only applies when the trial court has made – and the appellate court has reviewed – findings of fact. *See Branti v. Finkel*, 445 U.S. 507, 508-09 (1980) (indicating that the district court "hear[d] evidence for eight days" and "entered detailed findings of fact" before entering a permanent injunction); *Exxon Co., U.S.A. v. Sofec, Inc.*, 517 U.S. 830, 835, 841 (1996) (indicating that the issue on which there were "concurrent findings of fact" that this Court declined to review resulted from a "3-week bench trial in admiralty") (internal quotations omitted).

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September 28, 2009

AMICUS CURIAE BRIEF

Supreme Court, U.S.
FILED
JUN 15 2009
OFFICE OF THE CLERK

No. 08-586

In the Supreme Court of the United States

JERRY N. JONES, ET AL., PETITIONERS

v.

HARRIS ASSOCIATES L.P.

ON WRIT OF CERTIORARI
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FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

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QUESTION PRESENTED

Whether a security holder's claim that a mutual fund's investment adviser breached its fiduciary duty by charging an excessive fee—more than twice the fee it charged to clients with which it was not affiliated—is cognizable under Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-35(b), even if the security holder does not show that the adviser misled the mutual fund directors who approved the fee.

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BRIEF FOR THE UNITED STATES AS AMICUS CURIAE SUPPORTING PETITIONERS

INTEREST OF THE UNITED STATES

The United States, through the Department of Justice and the Securities and Exchange Commission (Commission or SEC), administers and enforces the federal securities laws. This case concerns Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-35(b), which provides that the investment adviser to a mutual fund "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services." Because an action under Section 36(b) may be brought either by a security holder or by the Commission, see *ibid.*, the United States has a substantial interest in this Court's resolution of the question presented.

STATEMENT

1. For decades, Congress has recognized that investment companies (such as mutual funds) require special regulation, different from that applying to other corporations under federal securities laws. See H.R. Rep. No. 1382, 91st Cong., 2d Sess. 2 (1970) ("At least as early as 1935, it was recognized by Congress[] that mutual funds * * * present special features which require attention beyond simply the disclosure philosophy of the Securities Act of 1933."). "[A]n investment company is typically created and managed by a pre-existing external organization known as an investment adviser," which "generally supervises the daily operation of the fund and often selects affiliated persons to serve on the company's board of directors." *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 536 (1984). As a result, "the relationship between investment advisers and mutual funds is fraught with potential conflicts of interest." *Ibid.* (internal quotation marks omitted).

Congress's concerns about "the potential for abuse inherent in the structure of investment companies" (*Burks* v. *Lasker*, 441 U.S. 471, 480 (1979)) led to the enactment of the Investment Company Act of 1940 (Act or ICA), ch. 686, 54 Stat. 789 (15 U.S.C. 80a-1 *et seq.*). The ICA initiated regulation of "most transactions between investment companies and their advisers," placed limits on "the number of persons affiliated with the adviser who may serve on the fund's board of directors," and required both "the directors and the shareholders of the fund" to approve the fees that the adviser receives "for investment advice and other services." *Daily Income Fund*, 464 U.S. at 536-537 (citing 15 U.S.C. 80a-17, 80a-10, and 80a-15). Section 36 of the ICA authorized the Commission to bring an action for injunctive relief

against any officer, director, board member, or adviser who committed an act of "gross misconduct or gross abuse of trust." 54 Stat. 841.

This Court has previously recounted the years of study and effort—by academics, the SEC, the mutual-fund industry, and congressional committees—that culminated in the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1413. See *Daily Income Fund*, 464 U.S. at 537-541. In brief, the enormous growth of mutual funds in the 1950s and 1960s prompted concerns that the ICA was not sufficiently protecting investors in mutual funds. A 1962 report commissioned by the SEC found that investment advisers tended to charge mutual funds "substantially higher" rates than they charged other clients and that mutual funds lacked effective bargaining power in the establishment of advisers' fees. *A Study of Mutual Funds Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 29, 30, 34, 66-67 (1962) (*Wharton Report*). In 1966, the Commission issued its own study, which concluded that lawsuits challenging excessive advisory fees had been largely ineffective because courts had applied an unduly permissive standard (relying on ratification by the board and shareholders and asking only whether a waste of corporate assets had occurred). *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 134-138, 141 (1966) (*1966 SEC Report*). The SEC concluded that board and shareholder approval could not protect shareholder interests with respect to advisory compensation because mutual funds

could not, as a practical matter, terminate their relationships with their advisers. *Id.* at 148.

Between 1967 and 1970, Congress considered legislation to address those concerns. See *Daily Income Fund*, 464 U.S. at 538-539. The resulting amendments to the ICA attempted to make mutual-fund boards "more independent of the adviser" and encouraged the boards to exercise "greater scrutiny of adviser contracts." *Id.* at 538 (citing 15 U.S.C. 80a-10(a), 80a-15(c)). But Congress also concluded "that the shareholders should not have to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board." *Kamen* v. *Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991) (internal quotation marks omitted). Accordingly, in amending the ICA in 1970, Congress added Section 36(b), 15 U.S.C. 80a-35(b), which created a "new" and "unique right" by giving security holders and the SEC an "independent check[] on excessive fees." *Daily Income Fund*, 464 U.S. at 535, 536, 541.

2. Section 36(b) provides in pertinent part as follows:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services * * * paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company * * * for

> breach of fiduciary duty in respect of such compensation[.]

15 U.S.C. 80a-35(b). In an action under Section 36(b), the "approval" of "compensation" by the investment company's board or shareholders "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. 80a-35(b)(2). The statute authorizes an award of "actual damages resulting from the breach of fiduciary duty," while providing that damages are not "recoverable for any period prior to one year before the action was instituted" and may not "exceed the amount of compensation or payment received" by the defendant from the investment company. 15 U.S.C. 80a-35(b)(3).

3. a. Petitioners are shareholders of three funds in the Oakmark complex of mutual funds. Pet. App. 16a; J.A. 562-563. Each of those funds is a part of a Massachusetts business trust registered with the SEC under the ICA as an open-end management investment company.[1] J.A. 563. Respondent serves as the investment adviser to the funds in the Oakmark complex pursuant to separate advisory agreements with each fund, which are negotiated with, and approved annually by, a single board of trustees representing the shareholders of the funds. JA. 563-564. Under the fee schedules accompanying the agreements, respondent receives an advisory fee that is calculated as a percentage of each fund's net assets at the end of the preceding month. *Ibid.*

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[1] An "open end" company is required "to redeem its securities on demand at a price approximating their proportionate share of the fund's net asset value at the time of redemption." *United States* v. *National Ass'n of Secs. Dealers, Inc.*, 422 U.S. 694, 698 (1975).

b. In August 2004, petitioners initiated this suit, alleging that respondent had breached its fiduciary duty under Section 36(b) by receiving advisory fees that were disproportionate to the services provided, and by impermissibly retaining savings it realized from economies of scale as the funds grew. J.A. 1, 52-53. Respondent moved for summary judgment, arguing that its advisory fees fell within the "range" of reasonable fees that could result from arm's-length bargaining, pursuant to the standard set out in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983). See Pet. App. 27a, 29a-30a. In opposing that motion, petitioners contended, *inter alia*, that the fees at issue were excessive because they were approximately twice as large as the fees that respondent charged its unaffiliated institutional clients for comparable services. *Id.* at 6a-7a, 30a, 39a.[2]

c. The district court granted respondent's motion for summary judgment. Pet. App. 15a. Invoking *Gartenberg*, the court found that petitioners had failed to raise a triable issue of fact as to "whether the fees charged to the [Oakmark] Funds were so disproportionately large that they could not have been the result of arm's-length bargaining between [respondent] and the board." *Id.* at 29a. The court "assum[ed] for the mere sake of comparison that the services [respondent's unaffiliated] institutional clients received were indistinguishable from those the [Oakmark] Funds received." *Id.* at

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[2] Petitioners also filed a cross-motion for summary judgment. The district court denied that motion (Pet. App. 22a-26a), and the court of appeals affirmed in relevant part (*id.* at 2a-4a). In this Court, petitioners do not request a ruling that summary judgment should be entered in their favor. Rather, they argue (Pet. Br. 19) that their "evidence warrants a trial on the merits."

30a. The court found more relevant, however, that "the amounts paid by different parties establish a range of prices that investors were willing to pay" for investment advice. *Ibid.* That broad range extended from "a low-end figure below what the institutional clients were paying" all the way to "a high-end figure beyond the fees that other mutual fund clients paid" their advisers. *Ibid.* Because respondent's fees fell within this spectrum of fees paid by both mutual funds and unaffiliated institutional clients, the court concluded they were not excessive. *Ibid.*

4. The court of appeals affirmed, concluding that respondent had not breached the fiduciary duty imposed by Section 36(b). Pet. App. 1a-14a.

The court of appeals expressly "disapprove[d] the *Gartenberg* approach," based on its view that "[a] fiduciary duty differs from rate regulation." Pet. App. 8a. The court explained that Congress's use of the term "fiduciary duty" in Section 36(b) "summon[s] up the law of trusts." *Ibid.* The court found that "the rule in trust law is straightforward: A trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay." *Ibid.*; see *ibid.* ("A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation."). The court stated that "when the settlor or the persons charged with the trust's administration make a decision, it is conclusive." *Id.* at 9a. It stated as well that "[f]ederal securities laws * * * work largely by requiring disclosure and then allowing price to be set by competition in which investors make their own choice." *Id.* at 13a. The court of appeals concluded that respondent had satisfied its fiduciary obligations because it had

not "pulled the wool over the eyes of the disinterested trustees or otherwise hindered their ability to negotiate a favorable price for advisory services." *Id.* at 14a.

While generally eschewing substantive reasonableness review of the fees charged by investment advisers, the court of appeals found it "possible to imagine compensation so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." Pet. App. 9a. The court concluded, however, that no such deviation from the norm could be established in this case because the fees that respondents charge the Oakmark funds "are roughly the same * * * as those that other funds of similar size and investment goals pay their advisers." *Id.* at 6a. Petitioners contended that, because "investment advisers create mutual funds" and "[f]ew mutual funds ever change advisers," the fees paid by other mutual funds typically are not the product of arm's-length bargaining and therefore do not provide a suitable benchmark for determining whether the fees respondent received from the Oakmark funds were excessive. See *ibid.* The court of appeals rejected that contention, stating that mutual funds have a strong incentive to keep fees low in order to attract investors. See *id.* at 7a. The court acknowledged that "beliefs about the structure of the mutual-fund market" were different when Section 36(b) was enacted in 1970. *Id.* at 11a. It concluded, however, that "[a] lot has happened in the last 38 years" and that the mutual fund market is now a competitive one where investors "can and do 'fire' advisers cheaply and easily by moving their money elsewhere." *Id.* at 11a-12a.

The court of appeals rejected petitioners' contention (see Pet. App. 6a, 13a) that the fees respondent charged the Oakmark funds were excessive because they were

substantially greater than the fees it charged unaffiliated institutional clients. The court stated that "[d]ifferent clients call for different commitments of time. Pension funds have low (and predictable) turnover of assets. Mutual funds may grow or shrink quickly and must hold some assets in high-liquidity instruments to facilitate redemptions." *Id.* at 13a. The court did not identify any record evidence in this case bearing on the comparability of the services that respondent provides to its affiliated and unaffiliated clients.

5. The court of appeals denied rehearing en banc, with five judges dissenting. Pet. App. 34a-35a. Judge Posner's opinion for the dissenters (*id.* at 34a-43a) concluded that the panel had erred in rejecting the *Gartenberg* standard based "mainly on an economic analysis that is ripe for reexamination." *Id.* at 37a. The dissenters identified as a "particular concern" that respondent "charg[es] its captive funds more than twice what it charges independent funds." *Id.* at 39a. They noted as well that, while the panel had suggested possible justifications for that disparity, those "suggestions are offered purely as speculation, rather than anything having an evidentiary or empirical basis." *Ibid.*

In the dissenters' view, the disparity between the fees that respondent charged its mutual-fund and unaffiliated clients called into question the panel's conclusion that competition among mutual funds for investors acts as a sufficient check on the compensation their advisers can charge. Pet. App. 40a-41a. For similar reasons, the dissenters disagreed with the panel's view that any excessiveness inquiry must be conducted "solely by comparing the adviser's fee with the fees charged by other mutual fund advisers." *Id.* at 41a. The dissenters explained that "[t]he governance structure that enables

mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor." *Ibid.* The dissenters instead endorsed "the *Gartenberg* approach," under which courts considering the possible excessiveness of fees may consider a broader range of evidence, including petitioners' proposed "alternative comparison" to the fees respondent charges its independent clients. *Ibid.*

SUMMARY OF ARGUMENT

The special "fiduciary duty" in Section 36(b) of the ICA, 15 U.S.C. 80a-35(b), was enacted out of concern that the non-arm's-length relationship between investment advisers and their affiliated investment companies could cause mutual funds to agree to excessive compensation. See *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 540-541 (1984). Although Congress did not choose to impose rate regulation on advisers, it did intend to create a check on compensation that is "independent" of the requirement that adviser contracts be approved by the funds' directors. *Id.* at 541. The court of appeals' construction of Section 36(b) defeats that purpose and departs from the statute's text.

A. The court of appeals' focus on whether an adviser has "ma[d]e full disclosure and play[ed] no tricks" on the investment company's board (Pet. App. 8a) is inconsistent with the plain text of Section 36(b), the structure of the ICA, the trust-law meaning of the term "fiduciary duty," and the purposes and legislative history of the statute. The statute specifies that the board's approval of compensation "shall be given such consideration by the court as is deemed appropriate under all the circumstances," 15 U.S.C. 80a-35(b)(2), which demonstrates

that a court should engage in a more encompassing inquiry than the court of appeals conducted. By creating a "fiduciary duty," Congress incorporated the established meaning of that term; and under trust law, an agreement about a trustee's compensation is not binding "if the agreement is unfair to the beneficiary." Restatement (Second) of Trusts § 242 cmt. i (1957) (Second Restatement). A disclosure-only test would effectively prevent Section 36(b) from providing the "independent check[]" on compensation that is needed to vindicate the essential purposes of the statute. *Daily Income Fund*, 464 U.S. at 541. That test is also inconsistent with contemporaneous evidence that the 1970 Congress expected Section 36(b) to prevent an adviser from overreaching in the amount of its fee even when a fully informed board consented to it.

B. In a Section 36(b) case, the court should not decide for itself (in the manner of a rate-setting agency) what compensation the adviser should receive, but should determine whether the adviser's fee is within the range of fees that arm's-length bargaining might have produced. That standard for determining the appropriateness of a fee, articulated by the Second Circuit in *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (1982), cert. denied, 461 U.S. 906 (1983), is consistent with the purposes of the statute, the legislative history, and this Court's articulation of the test for a fiduciary breach. See *Pepper* v. *Litton*, 308 U.S. 295, 306-307 (1939). In practice, *Gartenberg* has provided useful guidance for fund boards and has been incorporated into SEC regulations. The *Gartenberg* court's inquiry—an analysis of "all pertinent facts," potentially including the fees charged by the adviser for comparable

services rendered to unaffiliated clients—provides the appropriate way to resolve Section 36(b) cases.

The court of appeals relied too extensively on a comparison between the fees at issue here and those paid by other mutual funds. In light of the structural impediments to arm's-length bargaining between mutual funds and their investment advisers, an adviser's fee cannot automatically be declared lawful simply because it is comparable to fees paid by similar mutual funds. Although the court of appeals cited one study finding that advisory fees are constrained by competition among mutual funds for investors, that conclusion is a matter of ongoing debate. The weight to be given to a comparison with the fees paid by other mutual funds should depend on the evidence introduced in, and surrounding circumstances of, any particular case.

The court of appeals also erred by giving no effect to petitioners' allegations that respondent charges unaffiliated institutional clients half of what it charges mutual-fund clients for comparable services. An evaluation under Section 36(b) of "all the circumstances" should include consideration of any fees the adviser receives for providing comparable services to unaffiliated clients, such as pension funds and other institutional investors. Boards are encouraged to consider such information by industry best practices and SEC regulations, and courts appropriately may consider the same information. In this case, the parties appear to dispute whether the services respondent provides to its unaffiliated clients are comparable to those it provides to its affiliated mutual funds. On remand, the lower courts should determine whether petitioners have presented sufficient evidence to create a genuine issue of material fact and so to survive respondent's motion for summary judgment.

ARGUMENT

TO DETERMINE WHETHER AN INVESTMENT ADVISER HAS BREACHED ITS FIDUCIARY DUTY UNDER SECTION 36(b), A COURT MUST CONSIDER "ALL THE CIRCUMSTANCES," INCLUDING FEES RECEIVED FOR PROVIDING COMPARABLE SERVICES TO UNAFFILIATED CLIENTS

The court of appeals committed two fundamental errors in applying Section 36(b) of the ICA to the record in this case. First, the court viewed the investment adviser's "fiduciary duty" under the statute as limited to the provision of full and accurate information to the mutual fund's board. Second, the court indicated that, assuming Section 36(b) contemplates an inquiry into the substantive reasonableness of an adviser's fee in extreme cases, the fees paid by comparable mutual funds provide the only suitable benchmark for evaluating the fee. Because both of those propositions are wrong, the judgment of the court of appeals should be vacated, and the case should be remanded for further proceedings under the appropriate legal standards.

A. A Mutual Fund's Investment Adviser Violates Its "Fiduciary Duty With Respect To The Receipt Of Compensation" If It Negotiates And Receives An Excessive Fee, Even If It Has Fully Disclosed The Relevant Facts To The Fund's Board

The court of appeals held that an investment adviser's fiduciary duty to a mutual fund is satisfied whenever the adviser has made "full disclosure and play[ed] no tricks" on the board. Pet. App. 8a. The court indicated that, so long as such disclosure occurs, the board's approval is "conclusive" and Section 36(b) imposes no "cap" on the amount of compensation that the adviser may receive. *Id.* at 8a, 9a. The court of appeals' dis-

closure-only approach reflects an unduly limited view of the fiduciary duty created by Section 36(b). The text of Section 36(b) and complementary statutory provisions strongly indicates that a fully informed board's approval of compensation does not guarantee against a fiduciary breach. The statute's trust-law background, purposes, and legislative history reinforce that conclusion.

1. Section 36(b) of the ICA imposes on an investment adviser "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. 80a-35(b). For purposes of any suit to enforce that duty, Section 36(b)(2) specifies that "approval by the [mutual fund's] board of directors * * * of such compensation or payments * * * shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. 80a-35(b)(2). Thus, when an investment adviser is alleged to have breached his fiduciary duty to the mutual fund by negotiating and receiving a particular fee, the court should consider "all the circumstances" in determining whether a fiduciary breach has occurred. The court of appeals' approach contradicts the statute by making "conclusive" (Pet. App. 9a) the presence of a single "circumstance"—*i.e.*, that the board was apprised of all relevant information before it approved the adviser's fee. The text of Section 36(b) makes clear that Congress intended courts to engage in a fuller inquiry.

Moreover, other provisions of the Act and its companion statute oblige investment advisers to make disclosures and prohibit them from engaging in fraud. See 15 U.S.C. 80a-15(c), 80b-6. Under the court of appeals' disclosure-only approach, Section 36(b) requires no more of the investment adviser than compliance with those other provisions. To be sure, Section 36(b) estab-

lished new enforcement mechanisms, and so would not be wholly superfluous if the fiduciary duty it established merely tracked other statutory requirements. But if Congress had intended only to provide a new cause of action and additional remedies to enforce obligations established by other parts of the statutory scheme, it could have accomplished that purpose much more clearly and directly by authorizing damages suits for violations of the disclosure and anti-fraud provisions.

The language that Congress instead employed—which imposes on an investment adviser "a fiduciary duty with respect to the receipt of compensation for services" provided to a mutual fund, and instructs a court to consider "all the circumstances" in determining whether a breach has occurred—strongly indicates that Section 36(b) expands the substantive obligations imposed on investment advisers. That inference is buttressed by Section 36(b)(1), which states that, in a suit alleging that an investment adviser has breached its fiduciary duty, "[i]t shall not be necessary to allege or prove that any defendant engaged in personal misconduct." 15 U.S.C. 80a-35(b)(1). Failure to disclose all relevant facts to the board could reasonably be regarded as "personal misconduct," particularly when other parts of the statutory scheme require investment advisers to make such disclosures. Section 36(b)(1) thus also suggests that the adviser's fiduciary duty extends further than disclosure.

2. The court of appeals observed that the statute's use of the word "fiduciary" invokes the "law of trusts." Pet. App. 8a. The court of appeals understood general trust-law principles to provide that "[a] trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what [compensation] the settlor * * * agrees to

pay." Pet. App. 8a (citing Second Restatement § 242 & cmt. f (1957)). The court was correct that Section 36(b) should be construed to incorporate generally applicable trust-law principles. See, *e.g.*, *Varity Corp.* v. *Howe*, 516 U.S. 489, 502 (1996) (looking to "the common law, which, over the years, has given to terms such as 'fiduciary' * * * a legal meaning to which, we normally presume, Congress meant to refer"); *NLRB* v. *Amax Coal Co.*, 453 U.S. 322, 329 (1981) (explaining that the presumption that Congress intends "to incorporate the established meaning" of terms of art applies to "terms that have accumulated settled meaning under either equity or the common law"). The court, however, misunderstood the trust-law rules that apply to a fiduciary's periodic negotiation of his own compensation.

The annual fee negotiation between a mutual fund and its investment adviser is properly analogized not to the arm's-length negotiation between the settlor and a potential fiduciary at the outset of the relationship, but rather to agreements that the trustee reaches with the trust's beneficiaries after the trust has been established. In that context, a trustee's compensation may "be enlarged or diminished by an agreement between the trustee and the beneficiary," but the agreement will not be binding "if the trustee failed to make a full disclosure of all circumstances affecting the agreement which he knew or should have known *or if the agreement is unfair to the beneficiary*." Second Restatement § 242 cmt. i (emphasis added); see also *id.* § 216(3) & cmt. n. As one prominent commentator explained the underlying principle, the beneficiary's consent does not guarantee the validity of a transaction in which the trustee deals with trust property on his own behalf, because "the transaction is not like one between persons dealing with each

other at arm's length." 2 Austin Wakeman Scott, *The Law of Trusts* § 170, at 1298 (3d ed. 1967). As a result, such a transaction is "voidable if, but only if, the trustee failed to disclose to the beneficiaries the material facts which he knew or should have known, or if he used the influence of his position to induce the consent, or if the transaction was not *in all respects fair and reasonable*." *Ibid.* (emphasis added). In other words, proof of full disclosure will not prevent a court from making a further inquiry into the substantive terms of the transaction.

Although the Second Restatement reflects the state of trust law at the time Congress enacted Section 36(b), the same principle obtains today. "An agreement enlarging the trustee's compensation" will not "bind a consenting beneficiary if the trustee failed to disclose all the relevant circumstances that the trustee knew or should have known, or if the agreement is unfair to the beneficiary." Restatement (Third) of Trusts § 38 cmt. f (2003). Indeed, the current rule is that even when the amount of compensation is established by the terms of a trust—the example invoked by the court of appeals—a court can alter that amount upon finding it to be unreasonably high or low. See *id.* § 38 cmt. e ("If the amount of compensation provided by the terms of the trust is or becomes unreasonably high or unreasonably low, the court may allow a smaller or larger compensation[.]"); *id.* § 38 cmt. e illus. 2 ("The court's authority to modify or disregard a compensation provision is not limited to situations involving unanticipated developments[.]"); National Conference of Commissioners, *Uniform Trust Code* § 708(b)(2) (2005) (providing that a trustee is entitled to be compensated as specified by the terms of the

trust unless "the compensation specified by the terms of the trust would be unreasonably low or high").

In certain respects, Congress departed from generally applicable trust-law principles in crafting the new cause of action established by Section 36(b). Although a trustee normally bears the burden of establishing the fairness of a transaction that is alleged to violate the duty of loyalty,[3] Section 36(b)(1) provides that "the plaintiff shall have the burden of proving a breach of fiduciary duty." 15 U.S.C. 80a-35(b)(1). Congress also imposed limits on recovery, capping "actual damages" at the amount of compensation the investment adviser received, and providing that "[n]o award of damages shall be recoverable for any period prior to one year before the action was instituted." 15 U.S.C. 80a-35(b)(3).[4] Section 36(b) does not, however, contain any language that would preclude the usual inquiry into whether a trustee's compensation agreement is "unfair to the beneficiary." Second Restatement § 242 cmt. i. Thus, contrary to the court of appeals' conclusion (Pet. App. 8a-9a), the law of trusts strongly supports the proposition that courts may consider whether an investment adviser's annual fee is excessive, above and beyond determining that the adviser made full disclosure to the board.

3. The court of appeals' disclosure-only approach is also inconsistent with the purposes and legislative history of Section 36(b). As this Court has previously ex-

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[3] See *Pepper* v. *Litton*, 308 U.S. 295, 306 (1939) (noting the burden on a fiduciary to "show [a challenged transaction's] inherent fairness from the viewpoint of the [beneficiary]"); 2 Scott § 170.1, at 1304 ("[T]he burden of proof is upon the trustee to show that he did not take advantage of his position[.]").

[4] Cf. Second Restatement §§ 205 and 206 (containing no such limits).

plained, Congress intended the new fiduciary duty imposed by Section 36(b) to be a "check[] on excessive fees" that was "independent" of "directorial approval of adviser contracts." *Daily Income Fund*, 464 U.S. at 541. That new, independent check would have added very little if it required only "full disclosure" and the absence of "tricks" on the board (Pet. App. 8a), since other provisions of the ICA and its companion statute require disclosure and prohibit investment advisers from engaging in fraudulent conduct. See pp. 14-15, *supra*.

The legislative history also reveals a contemporaneous understanding—shared by the SEC and the entity representing investment companies and their advisers —that the fiduciary duty imposed by Section 36(b) would extend beyond an obligation to provide full and accurate information to the board. During the House Committee hearings about the bill that became the 1970 ICA amendments, Subcommittee Chairman Moss requested that both the SEC and the private-sector Investment Company Institute (ICI) (whose members held approximately 97.8% of the assets held by all open-end investment companies) provide written submissions about the "legal meaning" of the relevant statutory language. See *Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Fin. of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., Pt. 1, at 186, 187, 440 (1969). The memorandum submitted by the SEC concluded that a breach of Section 36(b)'s fiduciary duty "would occur when compensation to the adviser for his services is excessive in view of the services rendered—where the fund pays what is an unfair fee under the circumstances." *Id.* at 190. The memorandum submitted by Robert L. Augen-

blick, the President and General Counsel of the ICI, was to the same effect:

> Many words have been used in attempting to describe how far a fiduciary may go in negotiating his fee without violating his fiduciary relationship. A good way to put it is that he may not overreach in the amount of his fee even though the other party to the transaction, *in full possession of all the facts*, does not believe the fee is excessive.

Id. at 441 (emphasis added). That contemporaneous understanding, held by both the regulator and the regulatees, is directly contrary to the court of appeals' view (Pet. App. 8a-9a) that the board's approval of an adviser's fee is "conclusive" so long as "full disclosure" has occurred.

B. An Investment Adviser's Compensation Should Be Within The Range Of Fees That Might Have Been Negotiated Through Arm's-Length Bargaining, And A Comparison With The Fees The Adviser Charges Unaffiliated Clients For Comparable Services Is Relevant To The Section 36(b) Inquiry

For the foregoing reasons, an investment adviser's fiduciary duty under Section 36(b) extends beyond the obligation to disclose all relevant facts to the board, and includes the duty to refrain from charging an excessive fee. Although the court in a Section 36(b) case is not authorized to decide for itself (in the manner of a rate-setting administrative agency) what the appropriate fee should be, the court should determine whether the compensation received by the adviser is within the range of fees that arm's-length bargaining might have produced. In conducting that inquiry, the court should consider not only fees paid by other mutual funds, but also fees that

the adviser charges unaffiliated clients, so long as the services provided to the adviser's unaffiliated clients and its mutual-fund clients are shown to be comparable.

1. Section 36(b) prohibits an investment adviser from charging fees so disproportionately large that they could not have been negotiated through arm's-length bargaining

a. Before the court of appeals' decision in this case, the seminal case interpreting Section 36(b) was the Second Circuit's decision in *Gartenberg*, *supra*. The court in *Gartenberg* held that, "[t]o be guilty of a violation of [Section] 36(b), * * * the adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." 694 F.2d at 928; see *ibid.* ("[T]he test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all the surrounding circumstances."). Consistent with the statute's reference to "all the circumstances" and with the statute's legislative history, the court in *Gartenberg* stressed that "all pertinent facts must be weighed" in making that determination.[5] *Id.* at 929; see S. Rep. No. 184, 91st

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[5] The *Gartenberg* court itself considered the following non-exclusive series of factors: (1) the nature and quality of services provided to the fund and shareholders; (2) the profitability of the fund to the adviser; (3) fall-out benefits (including collateral benefits other than advisory fees that accrue to the adviser by virtue of its business with the fund and its shareholders); (4) economies of scale (including whether the adviser fairly shares with the fund and its shareholders any decreases in marginal operating costs owing to increased size); (5) comparative fee structure (meaning a comparison of the fees with those paid by similar

Cong., 1st Sess. 15 (1969) (*Senate Report*) ("[I]t is intended that the court look at all the facts in connection with the determination and receipt of such compensation * * * in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation."); H.R. Rep. No. 1382, 91st Cong., 2d Sess. 37 (1970) (*House Report*) (same).

The core of *Gartenberg*'s standard can be traced directly back to *Pepper*, *supra*, in which this Court observed that "[t]he essence of the test [for a fiduciary breach] is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." 308 U.S. at 306-307; see *id.* at 306 (noting that the transaction is to be examined for its "inherent fairness"). Indeed, that line from *Pepper* was quoted in the district court opinion that the Second Circuit affirmed in *Gartenberg*. See *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 528 F. Supp. 1038, 1047 (S.D.N.Y. 1981), aff'd, 694 F.2d 923 (2d Cir. 1982), cert. denied, 461 U.S. 906 (1983). And the Court in *Pepper* drew that standard from "certain cardinal principles of equity jurisprudence." 308 U.S. at 306. It is accordingly part of the "accumulated settled meaning under * * * equity" that Congress "incorporate[d]" into Section 36(b) by using the term *fiduciary*. *Amax Coal Co.*, 453 U.S. at 329.

The *Gartenberg* standard also furthers Congress's core purpose in enacting Section 36(b). Congress recognized that, because of the inherently close relationships between mutual funds and their investment advisers, "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do

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funds); and (6) the independence, expertise, care, and conscientiousness of the board in evaluating the contract. See 694 F.2d at 930-931.

in other sectors of the American economy." *Senate Report* 5; *House Report* 7 (same); see *Gartenberg*, 694 F.2d at 928 (quoting *Senate Report*). By requiring that the adviser's fee fall within the range that arm's-length bargaining might have produced, the *Gartenberg* standard advances Congress's objective of reducing the potential harm to investors of these non-competitive conditions.[6] Moreover, some of the specific factors that the *Gartenberg* court identified as relevant (see note 5, *supra*) were mentioned, along with other possible considerations, in the congressional committee reports or the SEC's 1966 report. See *Senate Report* 15; *House Report* 37; *1966 SEC Report* 144-145.

b. The SEC's regulations have recognized, and formalized, *Gartenberg*-like factors. In a 2004 rulemaking, the Commission amended several forms to require a specific discussion in proxy statements and shareholder reports of certain factors relevant to the board's approval of advisory fees and other amounts payable to an investment adviser. See *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, 69 Fed. Reg. 39,807-39,809 (2004) (amending Schedule 14A and Forms N-1A, N-2, and N-3).[7] In listing the factors to be discussed, the re-

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[6] This is not to say that Congress intended for the SEC to engage in "rate regulation" or for courts to engage in "[j]udicial price-setting." Pet. App. 8a, 10a. Indeed, the legislative history disclaims such a purpose. See *Senate Report* 6. Determining what outcomes fall outside the range that could result from an arm's-length negotiation is not the same as independently setting rates or prescribing a particular standard to produce prices, like a cost-plus model.

[7] A board is permitted to omit any particular factor it concludes is irrelevant to its evaluation of the investment advisory contract, as long as it explains why. 69 Fed. Reg. at 39,801 & n.32.

lease accompanying the amendments cited *Gartenberg* and noted that "[c]ourts have used similar factors in determining whether investment advisers have met their fiduciary obligations under section 36(b)." *Id.* at 39,801 n.31. The SEC's regulations require, *inter alia*, a discussion of any "comparison[] of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (*e.g.*, pension funds and other institutional investors)." 17 C.F.R. 240.14a-101, Sched. 14A, Item 22, para. (c)(11)(i); 69 Fed. Reg. at 39,807-39,809.

The *Gartenberg* standard—along with its non-exclusive list of potentially relevant factors—has provided useful guidance to fund boards fulfilling their obligation under Section 15(c) of the ICA of evaluating advisers' compensation. See, *e.g.*, Federal Regulation of Securities Committee, ABA, *Fund Director's Guidebook* 31-35 (3d ed. 2006); Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* 44-47 (July 2004) (*Best Practices*) <http://www.mfdf.com/site/documents/best_pra.pdf>. It also provides guidance for advisers in proposing fees. Moreover, the extent to which the adviser and the board exchange and reflect upon information of this kind helps a court to evaluate how much "consideration" to give a board's approval of an adviser's fee proposal. 15 U.S.C. 80a-35(b)(2). Although a board's approval is not "controlling" (*Senate Report* 15), the board's receipt of necessary information and its careful consideration of the *Gartenberg* factors prior to approving compensation can be strong probative evidence that the adviser has complied with its fiduciary obligation.

c. The *Gartenberg* approach provides the appropriate framework for resolving claims that an adviser has breached its fiduciary duty with respect to compensation. That approach is faithful to the statutory language and purposes, and it is consistent with the traditional trust-law standard for evaluating the conduct of fiduciaries dealing on their own account with entities to which they owe a duty.

Although this Court need not address the potential relevance of each "circumstance[]" that should be evaluated under Section 36(b)(2), two factors warrant further discussion in light of the court of appeals' rationale for rejecting petitioners' claims. As discussed below, in determining whether respondent's fees were consistent with those that could have been the product of arm's-length bargaining, the court of appeals gave too much weight to one factor (the fees paid by other mutual funds to their investment advisers) and too little to another (the fees paid to respondent by unaffiliated institutional clients for portfolio management).

2. In light of the structural impediments to arm's-length bargaining between mutual funds and their investment advisers, an adviser's fee cannot be declared lawful simply because it is comparable to fees paid by similar mutual funds

To the extent the court of appeals looked beyond the board's purportedly "conclusive" approval of respondent's fees, it treated the comparison between respondent's fees and other mutual funds' fees as effectively dispositive. Pet. App. 9a-13a. This comparison is surely relevant to the Section 36(b) analysis. Indeed, such an analysis was identified as one potential consideration (among others) in the SEC's 1966 Report. See *1966 SEC*

Report 144 (listing among "all relevant factors" the "fees paid for comparable services by other financial institutions with pools of investment capital of like size and purpose such as * * * other investment companies"). But the SEC and courts have long understood that comparisons of compensation among mutual funds should be treated with some caution. As the *Gartenberg* court explained, "the existence in most cases of an unseverable relationship between the adviser-manager and the fund it services tends to weaken the weight to be given to rates charged by advisers of other similar funds." 694 F.2d at 929 (citing *1966 SEC Report* 148). "Competition between money market funds for shareholder business does not support an inference that competition must therefore also exist between adviser-managers for fund business." *Ibid.*

The question of whether competition among mutual funds for investors keeps advisory fees in check remains the subject of lively debate. The court of appeals cited "[a] recent, careful study" to support its conclusion that investors subject advisory fees to "competitive pressure" by shopping among thousands of mutual funds. Pet. App. 12a (citing John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151 (2007)). Other studies, however, have reached the opposite conclusion. See *id.* at 40a-41a (Posner, J., dissenting from denial of reh'g en banc) (citing John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 609 (2001)); see also, *e.g.*, John P. Freeman, Stewart L. Brown, and Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 106-122 (2008) (responding to the

Coates and Hubbard study). After surveying the academic literature about mutual fund expenses, the Department of Labor recently concluded "that the available research provides an insufficient basis to confidently determine whether or to what degree [ERISA plan] participants pay inefficiently high investment prices," but still concluded that "there is a strong possibility that at least some participants, especially IRA beneficiaries, pay inefficiently high investment prices."[8] *Investment Advice—Participants and Beneficiaries*, 74 Fed. Reg. 3842 (2009); see also *id.* at 3840-3842 & nn. 24-31 (citing various articles and briefly describing their differing conclusions). Although not reaching a conclusion on the question, the SEC has similarly recognized that the level of fees charged by investment advisers to mutual-fund clients has become a subject of significant debate. 69 Fed. Reg. at 39,799.[9]

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[8] Mutual-fund advisers' fees have been the subject of litigation under the Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. 1001 *et seq.* Plaintiffs in such cases have alleged that plan fiduciaries breached their fiduciary duties under ERISA, see 29 U.S.C. 1104(a)(1), by allowing plans (or plan participants in individual-account plans) to pay excessive fees by purchasing certain mutual funds at retail rates. See, *e.g.*, *Young* v. *General Motors Inv. Mgmt. Corp.*, No. 08-1532-CV, 2009 WL 1230350, at *1 (2d Cir. May 6, 2009). Because Section 36(b) and ERISA have different statutory language, histories, and purposes, the resolution of this case should not establish the legal standard that should apply to excessive-fee claims against plan fiduciaries under ERISA.

[9] In its brief opposing certiorari (at 28), respondent quoted a document prepared by the SEC's staff as stating that "empirical evidence suggest[s] that there is significant competition based on costs in the fund industry." Memorandum from Paul F. Roye, Div. of Inv. Mgmt., to William H. Donaldson, Chairman 6 (June 11, 2003) <http://financialservices.house.gov/media/pdf/061803kanememo.pdf>. That staff-authored paper made clear that "the views expressed in this memorandum

Given that ongoing debate, the weight to be given to a comparison with the fees paid by other mutual funds should depend on the circumstances and evidence in each individual case. One factor to consider is the nature and amount of other probative evidence in the case (such as evidence concerning the fees the investment adviser received from unaffiliated clients for comparable services, see pp. 29-32, *infra*). In addition, case-specific evidence may indicate that competition is a more effective check on excessive advisory fees for the specific fund at issue (*e.g.*, because comparable funds are available and investors face minimal barriers in shifting their assets to those funds). The probative value of evidence concerning the fees paid by other mutual funds will also depend in part on how similar those funds are to the fund at issue in the lawsuit, and whether the services provided by their investment advisers are comparable. A court focusing on the concrete circumstances of an actual case could more confidently assess the extent to which competition for investor dollars provided adequate incentives for a particular adviser to reduce his fees, and thus counteracted the structural hindrances to arm's-length bargaining between the adviser and the mutual fund.

That less sweeping approach would be more faithful to Congress's purposes in enacting and retaining Section 36(b). The court of appeals remarked that "[a] lot has happened" in the mutual-fund market since Section

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may not necessarily reflect [the] views" of the Chairman or other Commissioners. *Id.* at 1. In addition, the staff's treatment was far from conclusive, noting that "it is difficult to measure the extent to which cost-based competition exists in the mutual fund industry," *id.* at 3, and that "the degree to which investors understand mutual fund fees and expenses remains a significant source of concern," *id.* at 12.

36(b) was enacted in 1970. Pet. App. 11a. But one thing that has not happened is any change in Section 36(b)'s statement of fiduciary duty. Congress's imposition of that duty was largely predicated on the assumption that disclosure and the pressures of the marketplace were not fully adequate to protect investors from "the potential for abuse inherent in the structure of investment companies." *Daily Income Fund*, 464 U.S. at 536 (quoting *Burks* v. *Lasker*, 441 U.S. 471, 480 (1979)). If applied globally, the court of appeals' finding that mutual funds' costs are effectively constrained by competition threatens to "eviscerate [Section] 36(b)." *Gallus* v. *Ameriprise Fin., Inc.*, 561 F.3d 816, 823 (8th Cir. 2009); see Pet. App. 41a (Posner, J., dissenting from denial of reh'g) ("The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the panel's comparability approach would if widely followed allow those fees to become the industry's floor.").

3. An evaluation under Section 36(b) of "all the circumstances" should include consideration of any fees the adviser receives for providing comparable services to unaffiliated clients

Just as a comparison with the fees paid by other mutual funds may be a relevant circumstance in evaluating an adviser's compensation under Section 36(b), so too may be a comparison with the fees that an adviser receives from clients with which it is not affiliated. Because negotiations for such fees typically occur between independent parties, each of which is subject to competitive pressures, they may provide better evidence of the prices that arm's-length bargaining would produce for the relevant services. For these reasons, such compari-

sons have played a major role in the debate about whether mutual fund fees are excessive. See *Daily Income Fund*, 464 U.S. at 537 (describing the *Wharton Report*'s finding "that investment advisers often charged mutual funds higher fees than those charged the advisers' other clients"). The 1966 SEC report—which initiated the legislative proposals that culminated in the enactment of Section 36(b)—expressly contemplated that the benchmarks for evaluating the reasonableness of investment advisers' fees could include "the costs of investment management services provided to pension and profit-sharing plans and other large nonfund clients." *1966 SEC Report* 145.

Current industry practice itself recognizes the potential relevance of this factor. The Mutual Fund Directors Forum recommended in 2004 that fund directors request and evaluate "meaningful information on the adviser's fee structures for any other comparable investment vehicles, both public and private, and an explanation of any differences from fees charged to the fund." *Best Practices* 45. And for the last several years, the SEC's regulations and forms have required boards to disclose in proxy statements and periodic reports to shareholders the consideration they give to the fees that their advisers charge to other clients. See 69 Fed. Reg. at 39,807-39,809. It would make little sense to preclude courts from considering for purposes of Section 36(b) the same kind of data that boards often consider for purposes of Section 15(c).

Of course, the fees an investment adviser charges unaffiliated clients will be relevant to the Section 36(b) analysis only to the extent that the adviser performs sufficiently comparable services in the two contexts. Here, petitioners claim to have presented evidence that

respondent charged its unaffiliated institutional clients approximately half of what it charged the Oakmark funds for comparable advisory services. Pet. Br. 9-10, 48-49; Pet. App. 6a-7a, 30a, 39a. The district court assumed *arguendo* that the services were in fact comparable, but discounted this evidence, treating as dispositive the similarity between respondents' fees from Oakmark and advisory fees paid by other mutual funds. See *id.* at 30a.[10] The court of appeals similarly slighted the comparison to unaffiliated clients, stating that "[d]ifferent clients call for different commitments of time," and suggesting that the provision of advisory services to mutual funds may be more difficult or time-consuming than the rendering of advice to unaffiliated clients. *Id.* at 13a. But that analysis is flawed on two different levels. First, the court offered no "evidentiary or empirical basis," *id.* at 39a (Posner, J., dissenting from denial of rehearing en banc), even for the generalization that advisory services to mutual funds are more difficult or costly to perform than advisory services to unaffiliated clients. Second, the appropriateness of the benchmark that petitioners advocate does not depend on whether investment advisers *typically* provide comparable services to their

[10] Both the comparison to the fees that respondent charged its unaffiliated institutional clients and the comparison to fees paid by other mutual funds reflect attempts to identify the range of compensation that could have resulted from an arm's-length negotiation. Those competing benchmarks are potentially subject to different infirmities. Compensation paid by other mutual funds provides an imperfect measure of what arm's-length bargaining would have produced because other mutual funds are also related to their investment advisers in ways that may suppress such bargaining. The comparison to fees paid by unaffiliated institutional clients eliminates that concern, but raises the question whether the services provided to different kinds of entities were in fact comparable.

mutual-fund and unaffiliated clients. Rather, if petitioners can show that *respondent* provides comparable services to the two types of clients, a substantial disparity between the fees respondent charges in the two contexts should be given significant weight in the Section 36(b) analysis, whether or not such comparability of services is characteristic of prevailing industry practices.

On remand, the lower courts therefore should consider whether petitioners—who bear the burden of proof, 15 U.S.C. 80a-35(b)(1)—have presented sufficient evidence about the comparability of services respondent provides to mutual-fund clients and unaffiliated clients to defeat respondent's motion for summary judgment.

CONCLUSION

The judgment of the court of appeals should be vacated and the case remanded for further consideration under the appropriate standards.

Respectfully submitted.

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JUNE 2009

AMICUS CURIAE BRIEF

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Supreme Court, U.S.
FILED
JUN 15 2009
OFFICE OF THE CLERK

No. 08-586

IN THE
Supreme Court of the United States

JERRY N. JONES, MARY F. JONES AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES, L.P.,
Respondent.

On Writ of Certiorari To The
United States Court of Appeals
For The Seventh Circuit

BRIEF OF AARP AND CONSUMER FEDERATION OF AMERICA AS *AMICI CURIAE* IN SUPPORT OF PETITIONERS

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STATEMENT OF INTEREST[1]

AARP is a nonpartisan, nonprofit membership organization of nearly 40 million persons age 50 and older. Its mission is to help people 50+ achieve independence, choice and control in ways that are beneficial and affordable to them and society. Through education, advocacy, and service, and by promoting independence, dignity, and purpose, AARP seeks to enhance the quality of life for all. In its efforts to foster the economic security of individuals as they age, AARP seeks to increase the availability, security, equity, and adequacy of public and private pension programs and the protections available to investors who accumulate savings outside of formal retirement plans.

Consumer Federation of America (CFA) is a non-profit association of 300 consumer groups, which in turn represent more than 50 million individuals. CFA advances the consumer interest through research, education, and advocacy. As increasing numbers of people have come to rely on the nation's financial markets to fund their retirement and invest their savings, CFA has made enhancing investor protection a top legislative and regulatory priority. CFA's policies in this area are based on a fundamental belief that investors are entitled to a

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[1] The parties have consented to the filing of this brief. *Amici curiae* state that no counsel for a party authored this brief in whole or in part, and no counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amici*, its members, or its counsel made a monetary contribution to the preparation or submission of this brief.

marketplace that provides them with a choice of appropriate investments and service providers, the information necessary to make informed choices, protection against fraud and abuse, and effective remedies when they are defrauded.

As part of their advocacy efforts to protect investors and preserve the legal means for redress when they are harmed in the marketplace, AARP and CFA have participated as *amici curiae* in numerous cases involving investor protections, including the scope of a fiduciary's duties as well as legislative and regulatory protections against fraudulent and deceptive conduct. AARP and CFA have filed *amicus curiae* briefs in cases involving the construction and application of federal securities laws. *See, e.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 128 S. Ct. 761 (2008) (AARP & CFA); *Merrill Lynch, Pierce, Fenner & Smith v. Dabit*, 547 U.S. 71 (2006) (AARP); *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005) (AARP & CFA); *SEC v. Edwards*, 540 U.S. 389 (2004) (AARP); *SEC v. Zandford*, 535 U.S. 813 (2002) (AARP & CFA). AARP also has filed briefs in numerous cases involving the duties of various fiduciaries involved in pensions and other retirement plans. *See, e.g.*, *LaRue v. DeWolff, Boberg & Assocs.*, 552 U.S. __, 128 S.Ct. 1020 (2008); *Varity Corp. v. Howe*, 516 U.S. 489 (1996).

Due to the vulnerability of retired persons and the critical role that mutual funds play in helping guarantee financial security in retirement, a top priority of AARP and CFA is to ensure that mutual

fund investors receive the full return on their investments to which they are entitled. The issues in this case directly bear on the fiduciary duty of mutual fund investment advisors and whether that duty includes an obligation not to charge excessive fees against the retirement accounts and other savings vehicles of millions of individuals. Mutual fund investors face significant risks if the Seventh Circuit's statement of the fiduciary duty prevails because it fails to recognize how the relationship between mutual funds and their investment advisers overrides traditional market forces that otherwise might ensure that advisers' compensation is consistent with their fiduciary duty. Because investment adviser compensation is deducted from mutual fund assets, resolution of the issues in this case will have a significant impact on the ability of current and future retirees to realize financial security in retirement. AARP and CFA, therefore, respectfully submit this brief *amici curiae* to facilitate the Court's decision in this case.

SUMMARY OF ARGUMENT

The Seventh Circuit's narrow interpretation of the fiduciary duty that a mutual fund investment adviser owes to the fund's investors under § 36(b) of the Investment Company Amendments Act of 1970, 15 U.S.C. § 80a-35(b), circumvents the intent of Congress in enacting § 36(b) and jeopardizes the ability of all American families to save sufficiently for retirement and for their children's future educational needs. Based on flawed assumptions about the competitive nature of the mutual fund industry and a flawed reading of the common law of

trusts, the Seventh Circuit disapproved of the reasonableness approach established in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), which had been followed by courts for almost thirty years. Instead the court held that the fiduciary duty created by § 36(b) means no more than a duty to refrain from "pull[ing] the wool over the eyes" of the fund's board. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 632 (7th Cir. 2008). In so holding, the Seventh Circuit significantly eroded the legal protections Congress created under the Investment Company Act and its subsequent amendments. The Seventh Circuit's holding that the investment advisor's § 36(b) fiduciary duty is breached by a failure to make full disclosure or by engaging in dishonest behavior ("play[ing] ... tricks," *id.*) is a correct statement of law insofar as it asserts a sufficient condition for a § 36(b) violation. But rather than limiting the investment advisor's duty as the court did in *Jones*, this Court should adopt an approach similar to that used by the Eighth Circuit's in *Gallus v. Ameriprise Fin. Inc.*, 561 F.3d 816 (8th Cir. 2009). *Gallus* applied traditional principles of fiduciary duty in requiring advisers both to make full disclosure and deal fairly with the funds they advise. *See id.* at 823. Under a interpretation of the statute, an adviser must both act properly in the negotiation process and ensure that a fair outcome results. Applying that rule, which is faithful to the common-law principles that § 36(b) incorporates, achieves the full measure of protection Congress intended under § 36(b).

ARGUMENT

I. MUTUAL FUND INVESTMENT FEES SIGNIFICANTLY REDUCE LONG-TERM SAVINGS FOR RETIREMENT AND FUTURE EDUCATION EXPENSES FOR VIRTUALLY ALL SAVERS IN THE NATION.

Ninety-one million individuals representing nearly half of all U.S. households (fifty-three million) and almost one-fifth of all household assets are invested in mutual funds. William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 TUL. L. REV. 1401, 1414 (2006) (citations omitted). This considerable percentage of individual wealth in the United States is invested in multi-purpose mutual fund investment vehicles. Mutual funds thus play a central role in savings for retirement and college education. Because a comparatively small current reduction in principal significantly reduces long-term returns on investment, the policies of the mutual fund industry, including those related to investment fees,[2] will seriously impact the future

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[2] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-126, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 5 (June 2000) [hereinafter GAO, MUTUAL FUND FEES] ("Mutual fund fees that investors pay include operating expenses, which cover the day-to-day costs of running a fund. . . . Generally shown as a percentage of the fund's average net assets, the annual total operating fee amount is referred to as the fund's operating expense ratio. The largest portion of a fund's expense ratio is generally the

wellbeing for the vast majority of American families.

A. Mutual Funds Are The Dominant Investment Vehicles For Retirement Savings.

Even with the attention being paid to the long-term health of the Social Security system, the widespread shift in employer-sponsored retirement plans from defined benefit plans ("DB plans") to defined contribution plans ("DC plans") has resulted in the retirement savings of tens of millions of Americans being invested in mutual funds. *See* Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 COLUM. BUS. L. REV. 934, 1018 (2008). DC plans have so eclipsed DB plans that by 2005, approximately 55 million participants were covered by DC plans, while only 21 million were covered by DB plans. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-530T, PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS CALLS FOR BETTER INFORMATION ON FEES 5 (March 2007) [hereinafter GAO REPORT: PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS]. Seventy-eight percent of mutual fund owners held DC accounts. INVESTMENT CO. INST., 2009 INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INVESTMENT COMPANY INDUSTRY 73 (49th ed. 2009), *available at* http://www.icifactbook.org/pdf/2009_factbook.pdf [hereinafter ICI FACT BOOK]. By the end of 2008, 95 percent of mutual fund investors claimed their

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fund adviser's compensation, which is used to cover its operating costs and earn profits for its owners.").

reason for investing in mutual funds was to save for retirement, and 69 percent of individuals invested in mutual funds held over half of their financial assets in mutual funds. *Id.* at 73. Moreover, IRAs and employer-sponsored DC plans accounted for approximately one-third ($3.1 trillion) of the $9.6 trillion in assets held by the United States mutual fund industry and 47 percent of all long-term mutual fund assets. *Id.* at 101.

A fundamental risk reallocation has occurred in the world of retirement planning. The shift to DC plans has eliminated the financial security previously provided by DB plans and it has consequently caused the retirement security for tens of millions of Americans to become dependent on a mutual fund's investment returns. Unlike the workings of a DB plan, which is generally funded solely by the employer and is required to provide a life-time annuity as a distribution option, there is no guaranteed benefit under a DC plan because the amount received is dependent upon the amount of employee and employer contributions and whether those investments experience growth or suffer losses during the life of the account. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-8, PRIVATE PENSIONS: LOW DEFINED CONTRIBUTION PLAN SAVINGS MAY POSE CHALLENGES TO RETIREMENT SECURITY, ESPECIALLY FOR MANY LOW-INCOME WORKERS 4 (2007); U.S. DEP'T OF LABOR, PENSION & WELFARE BENEFITS ADMIN., STUDY OF 401(K) PLAN FEES AND EXPENSES §1.1 (1998), *available at* http://www.dol.gov/ebsa/pdf/401krept.pdf. *See also Strengthening Worker Retirement Security: Before*

the H. Comm. On Education and Labor, 111th Cong. 5 (2009) (statement of John C. Bogle, Founder and former Chief Executive of the Vanguard Group), *available at* http://edlabor.house.gov/ documents/111/ pdf/testimony/20090224JohnBogleTestimony.pdf [hereinafter *Strengthening Worker Retirement Security*]. (describing this transition to DC plans as "a massive transfer from business enterprises to their employees of both investment risk (and return) and the longevity risk of retirement funding").

B. With The Advent Of 529 Savings Plans, Mutual Funds Are Central In Family Saving For Their Children's Educational Expenses.

Another important financial goal for individuals who invest in mutual funds is to plan and save for future educational expenses. ICI FACT BOOK, *supra*, at 104 ("[A]bout 12 percent of all U.S. households considered future education expenses their most important motivation for saving . . . [and] 25 percent of households that owned mutual funds in 2008 cited education as a financial goal for their fund investments").[3] Given the evolving labor market in the United States, education is increasingly seen as a central contributing factor "to individual success and to the nation's productivity and competitiveness." INVESTMENT CO. INST., A

[3] *See also* Investment Co. Inst., *A Guide to Understanding 529 Plans*, (2007), *available at* http://www.ici.org/pdf/bro_529_plans.pdf ("While most parents today expect their children to receive a postsecondary education, research shows that only one-third say they expect to be prepared to pay for their child's education.").

GUIDE TO UNDERSTANDING 529 PLANS, (2007), *available at* http://www.ici.org/pdf/bro_529_plans.pdf; *see also Grutter v. Bollinger*, 539 U.S. 306, 331 (2003) ("We have repeatedly acknowledged the overriding importance of preparing students for work and citizenship, describing education as pivotal to 'sustaining our political and cultural heritage' with a fundamental role in maintaining the fabric of society.") (quoting *Plyler v. Doe*, 457 U.S. 202, 221 (1982)). With proof that education levels contribute to disparities in earning potential, the ability to afford postsecondary education has become a concern for our nation. *See* INVESTMENT CO. INST., A GUIDE TO UNDERSTANDING 529 PLANS, 2 (2007), *available at* http://www.ici.org/pdf/bro_529_plans.pdf ("According to the Business-Higher Education Forum, the average difference in lifetime earning potential between someone who spends two years in college and a high-school graduate is $500,000. The typical bachelor's degree recipient can expect to earn about 67 percent—or about $1.5 million—more over a working life than a typical high school graduate.").

With the addition of section 529 to the Internal Revenue Code in 1999, 26 U.S.C. § 529, they have become one of the "fastest growing investment products in America." Mercer E. Bullard, *The Visible Hand In Government-Sponsored Financial Services: Why States Should Not Be Allowed to Offer 529 Plans*, 74 U. CIN. L. REV. 1265, 1265 (2006) [hereinafter Bullard, *Visible Hand*]. 529 plans provide a "tax-advantaged way for parents to invest for their children's college education." *Id.*

These plans are "state-sponsored, tax-deferred investment vehicles where the account value fluctuates based on the performance of the underlying investment," because "mutual funds are the predominant investment vehicles for 529 plans." *Id.* at 1267-68. At the end of 2008, 529 savings plans contained $89.4 billion, comprised of approximately 8.9 million accounts, with an average of approximately $10,000 per account. ICI FACT BOOK, *supra*, at 104.

C. Because Investment Fees Are Deducted From Retirement Plan Assets, Even A Seemingly Small Annual Percentage Fee Significantly Reduces The Ultimate Return On Mutual Fund Investments.

Investment fees associated with retirement and education savings have a significant impact on a plan participant's return on investment. Investment-adviser fees, which are the most costly fees associated with 401(k) plans and mutual funds, are usually paid by participants out of plan assets. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-21, PRIVATE PENSIONS: CHANGES NEEDED TO PROVIDE 401(K) PLAN PARTICIPANTS AND THE DEPARTMENT OF LABOR BETTER INFORMATION ON FEES 10 (2006). Such payments ultimately decrease the return on investment because the fees "are paid with funds that could otherwise be earning and compounding on a tax-deferred basis." *Are Hidden 401(k) Fees Undermining Retirement Security?: Hearing Before the H. Comm. On Education & Labor*, 110th Cong.

(2007) (testimony of Stephen J. Butler, President of Pension Dynamics Corporation, Author and Weekly Financial Columnist on "Undermining Worker's Retirement Security") *available at* http://edlabor.house.gov/testimony/030607StephenButlertestimony.pdf. This reduction in principal [or returns] can be critical, especially considering the low account balances of many 401(k) plans and 529 accounts,[4] and "can significantly decrease retirement [and education] savings over the course of a career." GAO REPORT: PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS, *supra*, at 10. This impact is demonstrated in a report by the Employee Benefits Security Administration:

> Assume that you are an employee with 35 years until retirement and a current 401(k) account balance of $25,000. If returns on investments in your account over the next 35 years average 7 percent and fees and expenses reduce your average returns by 0.5 percent, your account balance will grow to $227,000 at retirement, even if there are no further contributions to your account. If fees and expenses are 1.5 percent,

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[4] Most 401(k) account balances are not high to begin with: "[w]hile some participants have account balances of greater than $100,000, most have smaller balances. Based on industry estimates for 2005, 37 percent of participants had balances of less than $10,000, while 16 percent had balances greater than $100,000." GAO REPORT: PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS, *supra*, at 9-10].

> however, your account balance will grow to only $163,000. The 1 percent difference in fees and expenses would reduce your account balance at retirement by 28 percent.

U.S. DEP'T OF LABOR, EMPLOYEE BENEFITS SECURITY ADMINISTRATION, A LOOK AT 401(K) PLAN FEES 2, *available at* http://www.dol.gov/ebsa/pdf/401kFeesEmployee.pdf. A small difference in fee rates, therefore, substantially alters the amount of benefits a participant will have accumulated upon retirement.

This reduction in the ultimate retirement benefit caused by the imposition of excessive mutual fund investment fees jeopardizes the ability of countless current workers to become financially self-sufficient in retirement. *See Strengthening Worker Retirement Security*, *supra*, at 5. In describing the dangers of high costs, Mr. Bogle quoted an article that he wrote in the *Journal of Portfolio Management*: "These enormous costs seriously undermine the odds in favor of success for citizens who are accumulating savings for retirement. Alas, *the investor feeds at the bottom of the costly food chain of investing*, paid only *after* all the agency costs of investing are deducted from the markets' returns." *Id.* at 3. It is difficult to square this state of affairs with the fiduciary that Section 36(b) imposes on investment advisers.

II. THE SEVENTH CIRCUIT'S RATIONALE FOR A NARROW 36(b) FIDUCIARY DUTY FAILS TO CONSIDER MARKET FAILURES IN THE MUTUAL FUND INDUSTRY THAT PROMOTE RESTRICTIONS ON THE ABILITY OF INVESTORS TO NEGOTIATE AT ARM'S LENGTH WITH MUTUAL FUND ADVISORS.

The Seventh Circuit's decision to narrow the § 36(b) fiduciary duty rests on a specious perception that the market for investment fees in the mutual fund industry is perfectly competitive, and therefore additional controls are not necessary to keep such fees fair.[5] Contrary to the court's assertion that "[m]utual funds come much closer to the model of atomistic competition than do most other markets," *Jones*, 527 F.3d at 634, a report by the United States Government Accountability Office found that "[t]he structure and nature of competition in the mutual fund industry appear to resemble the type of market referred to by economists as 'monopolistic competition.'" U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/GGD-00-126, MUTUAL FUND FEES: ADDITIONAL DISCLOSURE COULD ENCOURAGE PRICE COMPETITION 56 (June 2000) [hereinafter GAO, MUTUAL FUND FEES]. The monopolistic nature of competition in the mutual fund industry that focuses attention on brand and reputation allows investment advisors to deflect attention from the fact that, although returns

[5] The Seventh Circuit states: "[a]n adviser can't make money from its captive fund if high fees drive investors away." *Jones*, 527 F.3d at 632.

are competitive within the industry, they would be substantially higher if investment advisors were forced to compete on the basis of price.

A. Contrary To The Assertion Of The Seventh Circuit, Investment Advisors In The Mutual Fund Industry Do Not Compete On The Basis Of Price.

The court argues that price competition protects investors by reducing costs. However, evidence suggests that mutual fund "managers do not compete on costs." John C. Bogle, Lecture, *A New Order of Things: Bringing Mutuality to the "Mutual" Fund*, 43 WAKE FOREST L. REV. 1089, 1113-14 (2008). The General Counsel to the SEC has noted that the mutual fund industry defies the "law of one price,"[6] concluding that if "we're not seeing the price convergence one would expect," then the industry "may be depriving American investors of the long-term returns they deserve." Brian G. Cartwright, Gen. Counsel, SEC, Remarks before the 2006 Securities Development Conference (Dec. 4, 2006), *available at* http://www.sec.gov/news/speech/2006/spch120406bgc.htm. "Under the normal rules of capitalism, any industry that can produce double-digit annual growth should soon be swamped by eager competitors until returns are driven down. But . . . that does not seem to be happening . . .

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[6] The "law of one price" is a principle that "in an efficient, competitive market, nearly identical goods will sell at nearly identical prices . . . because with full information . . . no rational buyer would pay more." Cartwright, *supra*.

because most fund managers do not compete on price." *Money for Old Hope*, THE ECONOMIST, 3 (Mar. 1, 2008); *see also GAO*, MUTUAL FUND FEES, *supra*, at 7 ("[C]ompetition in the mutual fund industry may not be strongly influencing fee levels because fund advisers generally compete on the basis of performance (measured by returns net of fees) or services provided rather than on the basis of the fees they charge."). SEC Chairman Christopher Cox has remarked that "because of a regulatory cumbersomeness that *obscures the real numbers*, our financial services industries are able to *skim off* much more of the assets they handle than would be the case in a well-functioning market." Christopher Cox, Chairman, SEC, Address to Mutual Fund Directors Forum Seventh Annual Policy Conference (Apr. 13, 2007) (emphasis added), *available at* http:www.sec.gov/news/speech/2007/spch041207cc.htm. Therefore fees are higher than they would be if investment advisers were forced to compete on the basis of price.

B. Mutual Fund Directors Do Not Bargain At Arm's Length On Behalf Of Fund Investors.

Unlike beneficiaries of pension funds, who benefit from having plan managers negotiate with investment advisors to reduce investment fees, individual investors in mutual funds lack collective bargaining power to lower investment fees because mutual fund directors are captives of their investment advisors. "Compensation for [advisory] services is determined under an advisory contract, the terms of which are all too often dictated to

unwary or negligent fund directors and fund shareholders by the investment adviser" *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 808 (2d Cir. 1976). Unlike a normal business where the "firm's management is free to hire and fire outside service providers, [the mutual fund industry's] outside managers actually have *de facto* control of the fund and its board." John P. Freeman et al., *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 87 (2008) [hereinafter Freeman et al., *Advisory Fees: New Evidence*]. A mutual fund adviser "often has the ability [at the initial stages of establishing the fund] to influence who will sit on the fund's board of directors," *Gallus*, 561 F.3d at 820, consequently increasing the likelihood that boards will behave favorably to the investment advisors.

> Since a typical fund is organized by its investment adviser which provides it with almost all management services . . . , a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arm's length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

Burks v. Lasker, 441 U.S. 471, 480 (1979) (citing S. Rep. No. 91-184, 91st Cong., 2d Sess. (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4901). Because mutual funds "cannot move easily from one adviser-manager to another," *Gartenberg*, 694 F.2d

at 929, "'investment advisors seldom, if ever, compete with each other for advisory contracts with mutual funds.'" *Id.* (quoting Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R.Rep. No. 2337, 89th Cong., 2d Sess. 126, 131, 148 (1966)). Moreover, Judge Posner has noted that connections between the mutual fund industry agents "'foster favoritism, to the detriment of investors. Fund directors and advisory firms that manage funds hire each other preferentially based on past interactions. When directors and the management are more connected, advisors capture more rents and are monitored by the board less intensely.'" *Jones*, 537 F.3d at 730-31 (Posner, J., dissenting from denial of rehearing en banc) (quoting Camelia M. Kuhnen, *Social Networks, Corporate Governance and Contracting in the Mutual Fund Industry*, (Mar. 1, 2007), *available at* http://ssrn.com/abstract=849705).

The significance of the captive nature of these funds cannot be understated. A comparison to Vanguard mutual funds, which are not captive because of the use of outside "sub-advisers," demonstrates that the average advisory fee rate charged by the industry's 500 largest equity funds is nearly five times higher than that charged by Vanguard. *See* Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 101. *See also Jones*, 537 F.3d at 731-32 (Posner, J., dissenting from denial of rehearing en banc) ("'[T]he chief reason for substantial advisory fee level differences between equity pension fund portfolio managers and equity

mutual fund portfolio managers is that advisory fees in the pension field are subject to a marketplace where arm's-length bargaining occurs. As a rule, [mutual] fund shareholders neither benefit from arm's-length bargaining nor from prices that approximate those that arm's-length bargaining would yield were it the norm.'" (quoting John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 634 (2001))).

Moreover, mutual fund directors do not feel compelled to negotiate lower investment fees because they believe in the theory of "consumer acceptance in the absence of deceit." Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1037 (2005). Proponents of the laissez faire theory of market governance argue that because investors can easily exit a mutual fund, their continued investment is ample evidence that investors do not see investment fees as too high. Many "independent directors of mutual funds . . . share this normative vision based on consumer sovereignty . . . and [are] chosen *because* they do." *Id.* at 1038 (emphasis added). Because they view shareholders as being "responsible for their own choices, directors are less likely to feel obliged to act aggressively on their behalf." *Id.*; *see, e.g.*, Mercer E. Bullard, *The Mutual Fund Summit: Context and Commentary*, 73 MISS. L.J. 1129, 1142-43 (2004) (remarking on discussion between SEC Commissioner Harvey Goldschmid

who believes that "independent directors . . . have to be far more effective and active than they've been in the past" and an industry insider who argues that the board of a mutual fund should not engage in "a negotiation process; [rather] its' [sic] an oversight process . . . (T)he independent directors are asked to look over the process . . . (and) make sure that the fee arrangement is within a band of reasonableness").

However, this theoretical justification for a limited role of the directors and the difference in investment fees is undermined because high prices are pervasive throughout the industry. *See, e.g.* Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 93; Freeman & Brown, *supra*, at 640 (finding the problem of excessive fees exists both in actively and passively managed mutual funds. Investment fees for mutual index funds are more than ten times higher than comparable pension index funds). The pervasiveness of high fees deprives investors of the choice to "vote with their feet" based on their dissatisfaction with the rate of investment fees. Leaving one high-priced mutual fund merely provides the investor with the ability to invest in a competing high priced mutual fund. The result is a circular process in which investors tolerate higher fees because they lack realistic alternatives while directors tolerate higher fees because they misinterpret continued investment as consent to higher fees. Therefore, the laissez faire theory of market regulation permits mutual funds to compete solely on the basis of investment return while ignoring the congressional interest in moderating

investment fees. So long as investment fees are not so high that they reduce the competitiveness of the fund's return on investment, absent meaningful enforcement of the fiduciary duty, there is no mechanism to ensure that investment advisors are not reaping huge rewards at the expense of the retirement funds of tens of millions of Americans.

C. Investors In Mutual Funds Are "Captive Investors" Not Freely Able To Reinvest In Competing Mutual Funds.

Another reason investment advisors are able to avoid price competition is that, contrary to the Seventh Circuit's assumption that investors are able to protect themselves by simply "firing" advisers and "moving their money elsewhere," *Jones*, 527 F.3d at 634, many investors in mutual funds are "captive investors" in that they cannot freely exit and move their money to an alternative fund.[7] Before switching out of a fund, an investor must weigh many factors to determine whether it would be cost effective. *See* Caroline J. Dillon, *Do You Get What You Pay For? A Look at the High Fees and Low*

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7 The accuracy of the Seventh Circuit's contention that "investors can and do protect their interests by shopping" has further been called into question because the "careful study" cited by the court to support this proposition was funded in large part (over $100,000) by the Investment Company Institute, a national association of investment companies. Asher Hawkins, *Well-Funded Opinion*, Forbes Magazine (May 8, 2009), *available at* http://www.forbes.com/2009/05/07/mutual-funds-fidelity-columbia-business-school-personal-finance-hubbard.html.

Protections of Mutual Funds, 2006 COLUM. BUS. L. REV. 281, 303 (2006) (noting that there may be hidden costs such as "capital gains taxes and payments of a sales load on a new fund" which "overshadow any benefits that a shareholder may receive when moving to a fund with lower fees") (citations omitted). For example, in the context of 529 plans, the ability of investors merely to switch out of a fund anytime they find fees to be exorbitant is limited by the enabling statutory scheme. A 529 plan must meet several requirements in order for an investor to benefit from the federal and state tax advantages of the 529 statutory scheme:

> Participants may not direct the investment of their contributions or earnings in the plan except in selecting from among different broad-based investment strategies designed exclusively for the 529 plan. Once the initial selection is made at the time of a contribution, transfers to other options may occur only once per calendar year or when the beneficiary is changed.

Bullard, *Visible Hand*, *supra*, at 1269 (citations omitted). Additionally, in the context of retirement plans, participants in 401(k) plans who are mutual fund investors may fairly be characterized as "captive investors," because they may only select funds from a limited menu of options provided to them by their plan administrators.

D. The Magnitude Of The Impact That Fees Have On Mutual Fund Investments Is Less Than Transparent To Investors.

The disclosures to employees and retirees fail to provide a "simple way for participants to compare fees among investment options." GAO REPORT: PRIVATE PENSIONS: INCREASED RELIANCE ON 401(K) PLANS, *supra*, at 15. "Information on fees is disclosed to participants in a piecemeal way. In order to get a more complete picture of fees, participants must collect various documents over time." U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-21, PRIVATE PENSIONS: CHANGES NEEDED TO PROVIDE 401(K) PLAN PARTICIPANTS AND THE DEPARTMENT OF LABOR BETTER INFORMATION ON FEES, 17-18 (Nov. 2006) ("[T]o piece together certain fees associated with a plan's investment options, a participant often must collect multiple prospectuses or fund profiles. Furthermore, because ERISA does not require that these documents be provided automatically to all participants, some participants may need to request them but may not know to do so"); *see also* Jon Forman, *Taking on 401 (k) Plan Fees that Take Away From You*, THE JOURNAL RECORD, Jan. 8, 2007, at 6A, *available at* http://jay.law.ou.edu/faculty/jforman/Opeds/2007-1(401kFees).htm ("Fees, especially investment fees, are Wall Street's dirty little secret. It is extremely difficult for investors to get a complete picture of the

fees that fund managers skim off the top. Fund managers rarely advertise how much they make on your money.").

The problems surrounding the lack of disclosure regarding fees charged to participants has recently been recognized by the SEC. *See* Dillon, *supra*, at 302 (citing SEC, DIV. INV. MGMT.: REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm#item13. Owing to questionable disclosure practices, participants often are unaware fees are even being charged to their plans. According to a recent AARP survey, "more than eight in ten (83%) participants acknowledged that they actually do not know how much they pay in fees and expenses associated with their own plan." AARP, COMPARISON OF 401(K) PARTICIPANTS' UNDERSTANDING OF MODEL FEE DISCLOSURE FORMS DEVELOPED BY THE DEPARTMENT OF LABOR AND AARP, 1 (2008).

This lack of knowledge may be due in part to the fact that participants are led to believe that there are no fees being charged, when that is simply not the case:

> [F]ees collected by bundled providers are generally always charged against participants' accounts. Because the plan sponsor is not paying a fee for services directly to the service provider, bundled providers will present the plan to the plan sponsor

> as having 'free' recordkeeping and administration. There is currently little to no disclosure of this to either plan sponsors or plan participants. There are literally tens of thousands of 401(k) plans that report zero costs for recordkeeping and administration on their annual report [ ] filed with the Department of Labor. In actuality, participant accounts are being charged for these 'free' plan services in the form of investment fees assessed against their accounts.

Hidden 401(K) Fees: How Disclosure Can Increase Retirement Security: Hearing before the Special Committee on Aging, 3, 110th Cong. (2007), (statement of Michael Kiley, President/CEO of Plan Administrators, Inc. on behalf of ASPPA and CIKR) *available at* http://aging.senate.gov/events/hr182mk.pdf.

Moreover, the current market structure tolerates a symbiotic relationship between sophisticated financial advisers and naïve investors. *Strengthening Worker Retirement Security*, *supra*, at 14 (quoting Davis F. Swensen, Chief Investment Officer at Yale University, who stated that "'[t]he drive for profits by Wall Street and the mutual fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome: . . . the powerful financial services industry exploits vulnerable individual investors . . . .'"). Because investors lack the knowledge to interpret

investment options, even if information is provided, they are reliant upon investment advisors to get adequate returns on their investments. It is because of this special relationship and the market failures associated with the investment fee negotiations that investment advisors owe a fiduciary duty to their investors.

E. Pervasive Conflicts Of Interest Within The Mutual Fund Industry Cause Investment Advisors To Exploit The Lack Of Price Competition To The Detriment Of Investors.

The Seventh Circuit's limited analysis also overlooks the potential for conflicts of interest, which are inherent in the external management arrangement of mutual funds, to cause investment advisors to take advantage of the lack of price competition for their own gains. "[M]anagement companies [ ] seek to earn high returns for fund investors, to be sure, but seek at the same time to earn the highest possible returns for themselves." Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 88 (quoting John C. Bogle, Honing the Competitive Edge in Mutual Funds, Remarks Before the Smithsonian Forum 5 (Mar. 23, 1999) (transcript on file with the authors)); *see also* Langevoort, *supra*, at 1019 ("The typical mutual fund is organized by a sponsor who expects to profit by providing advisory and other services to the fund, with returns growing as the fund grows in size.") (citation omitted). "Mutual funds are unique . . . in that they are 'organized and operated by people whose primary

loyalty and pecuniary interest lie outside the enterprise.'" *Role of Indep. Dirs. of Inv. Cos.*, Securities Act Release No. 33-7754 [1999-2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,212, at 82,451 (Oct. 14, 1999).

The financial incentive coupled with the opportunity created by the captive nature of the mutual fund drives investment advisers to "increase assets at shareholder expense even though increasing the size of the fund does not increase (and can sometimes decrease) returns to its investors." Langevoort, *supra*, at 1020 (citations omitted). "If the industry remains dominated by conflicts of interest, then excessive fees will be the norm, and the norm should not be made the benchmark for propriety." *Id.* at 1023-24 (citations omitted). Despite these conflicts of interest, there is little incentive for directors of mutual funds to monitor the activities of their investment advisors. *See Jones*, 537 F.3d at 730 (Posner, J., dissenting from denial of rehearing en banc) ("The panel bases its rejection of *Gartenberg* mainly on an economic analysis that is ripe for reexamination on the basis of growing indications that executive compensation in large publicly traded firms often is excessive because of the feeble incentives of boards of directors to police compensation").

III. THE SEVENTH CIRCUIT'S INTERPRETATION OF THE SCOPE OF THE SECTION 36(b) FIDUCIARY DUTY IS INCONSISTENT WITH THE STATUTORY TEXT, THE COMMON LAW OF TRUSTS, AND THE CONGRESSIONAL INTENT TO PROTECT MUTUAL FUND INVESTORS FROM EXCESSIVE INVESTMENT FEES.

With more Americans entrusting their retirement and education savings to mutual funds, Congress' goal of protecting investors from the significant impact of excessive investment fees is more important than ever. The Investment Company Act of 1940 ("ICA"), 15 U.S.C. § 80a-1 *et seq.*, provides legal protection to individuals invested in mutual funds. Section 36(b) specifies that "the investment adviser of a registered investment company shall be deemed to have a *fiduciary duty* with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b) (emphasis added).

A. The Seventh Circuit's Interpretation Of The 36(b) Fiduciary Duty Is Inconsistent With The Statutory Text.

The Second Circuit in *Gartenberg* created the standard that courts have turned to for the past three decades to define an investment adviser's "fiduciary duty" under section 36(b).[8] *See Gallus*,

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[8] *See Gallus*, 561 F.3d at 821 ("A number of courts have indicated approval of the *Gartenberg* framework in cases

561 F.3d at 821 (referring to *Gartenberg* as the "starting point for interpreting a fund adviser's fiduciary duty"). The Second Circuit found that "the test is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's length in the light of all surrounding circumstances." *Gartenberg*, 694 F.2d at 928.

Unlike the Seventh Circuit's blanket statement that a fiduciary "is not subject to a cap on compensation," the *Gartenberg* standard gives meaning to all sections of the 36(b), particularly the provision of subparagraph (1) that "it shall not be necessary to allege or prove that any defendant engaged in personal misconduct." 15 U.S.C. § 80a-35(b)(1). The Seventh Circuit's narrow interpretation of the fiduciary duty to entail a duty merely to "make full disclosure and play no tricks," squarely conflicts with subparagraph (1) because these bad acts necessarily would require allegations and proof of personal misconduct. Instead, a focus on the reasonableness and fairness of the transaction, as suggested by the broader reading of the fiduciary duty under the common law, adequately gives

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challenging adviser's fees under § 36(b).") (citing *Krantz v. Prudential Invs. Fund Mgmt. L.L.C.*, 305 F.3d 140 (3d Cir. 2002) (following a Fourth Circuit analysis that was based on *Gartenberg*); *Migdal v. Rowe Price-Fleming Int'l*, 248 F.3d 321 (4th Cir. 2001); *Forsythe v. Sun Life Fin., Inc.*, 417 F.Supp.2d 100 (D. Mass. 2006); *Sins v. Janus Capital Mgmt., L.L.C.*, 2006 WL 3746130 (D. Colo. 2006); *In re Dreyfus Mut. Funds Fee Litig.*, 428 F. Supp. 2d 342 (D. Pa. 2005); *Zucker v. Aim Advisors, Inc.* 371 F. Supp. 2d 845 (S.D. Tex. 2005); *Strigliabotti v. Franklin Res., Inc.*, 2005 WL 645529 (N.D. Cal. 2005)).

meaning to all provisions of the ICA text.

B. The Seventh Circuit Applies An Incomplete Interpretation Of The Common Law Of Trusts.

Because Congress did not define "fiduciary duty" as used in the context of the ICA, *see Gartenberg*, 694 F.2d at 928, one must look to the "accumulated settled meaning" of the term under common law." *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329-30 (1980). The Seventh Circuit correctly observed that the term "fiduciary duty" has been given substantial meaning by the common law of trusts. *Jones*, 527 F.3d at 632 (citing *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989)). In contrast, the Seventh Circuit's misreading of the common law led it to conclude that the fiduciary duty is "straightforward" and only entails "an obligation of candor in negotiation, and honesty in performance" - an obligation the court watered down considerably by holding that the adviser is not liable unless it "pulls the wool over the eyes" of the fund's board. *Jones*, 527 F.3d at 635. A more faithful review of pertinent common law reveals that "a person in a fiduciary relationship to another is under a duty to act for the benefit of the other," *Restatement (Third) of Trusts* § 2 cmt. b (2003), and when negotiating its compensation with the one to whom it owes a duty, must both provide full disclosure of all material facts and ensure that the compensation is fair. *See, e.g., Restatement (Second) of Trusts* §§ 2 cmt. b, 170(2), 242 cmt. i (1959).

Moreover, the fiduciary duty under the common law of trusts also entails "a duty not to profit at the expense of the other . . . without the latter's consent." *Restatement (Third) of Trusts* § 2 cmt. b (2003). Although advisers arguably receive formal consent through approval of their compensation contracts by the fund's board, even where there is consent, "if the fiduciary enters into a transaction with the other and . . . the transaction is unfair to the other, the transaction can be set aside by the other." *Id.*; *see also Restatement (Second) of Trusts* § 216(2)(b), (3). Because of economies of scale and the market failures that are pervasive in the mutual fund industry, *see infra*, excessive investment fees are not the result of a fair, arm's length negotiation. Thus, the Seventh Circuit's narrow interpretation of the fiduciary duty derives scant support from common law.

C. The Eighth Circuit's Test Is Consistent With The Congressional Intent Behind The ICA.

The Seventh Circuit's decision seems to be premised upon a theory of *laissez faire* market control that justifies the outcome of a transaction on "consumer acceptance in the absence of deceit." Langevoort, *supra*, at 1037. According to the theory, because mutual fund investors can "vote with their feet," the fact that investors remained invested in mutual funds indicates consumer consent to pay investment fees. *Id.* at 1038. This strain of academic finance dogma finds no support in the history and purpose of Section 36(b). Congress was unwilling to

allow investment fees to be determined solely on the basis of market forces. Instead of relying on existing statutory and common law consumer protections against false advertising and fraud, Congress enacted a fiduciary duty specifically related to the compensation of investment advisors.

The Court has previously acknowledged that the congressional purpose of the ICA was more than merely an interest in transparency and honesty in negotiations, noting a report commissioned by the SEC which found that "the structure of the [mutual fund] industry, even as regulated by the Act, had proven resistant to efforts to moderate adviser compensation." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 537 (1984) (citation omitted). In fact, § 36(b) was added to the statute based in part on the SEC's "concern that the structural requirements for investment companies imposed by the Act [including the Act's provisions for independent directors and approval of advisor contracts] would not alone ensure reasonable adviser fees." *Id.* at 539-40. Consequently, the Senate Report proposing the final version of § 36(b) noted that shareholder and director approval of advisor contracts "would not be controlling in determining whether or not the fee encompassed a breach of fiduciary duty." *Id.* at 540 (citing S. Rep. No. 91-184, 1970 U.S.C.C.A.N., *supra*, at 4910). Therefore, the common law's fairness requirement and the standard articulated in *Gallus* and *Gartenberg* more faithfully serve the congressional interests both in ensuring that investors benefit from savings caused by economies of scale and in restoring investors to the bargaining

positions they would have occupied but for market failures within the mutual fund industry.

1. The Protection Of A Fairness Standard Is Necessary Because The Unprecedented Size Of Most Mutual Funds Has Created An Environment In Which Investment Fees Become Unfair To Investors Due To Economies Of Scale.

The Court has recognized that because investment advisor compensation is typically based on a set percentage of the fund's assets rather than on services performed, "as a fund's assets grew, this form of payment could produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio." *Daily Income Fund, Inc.*, 464 U.S. at 537 (citation omitted); *accord.*, *Migdal v. Rowe Price-Fleming Int'l, Inc.*, 248 F.3d 321 (4th Cir. 2001); *Kalish v. Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1237 (S.D.N.Y. 1990) ("The concept of 'economies of scale' assumes that as a mutual fund increases in size, its operational costs decrease proportionally"). The Fourth Circuit recognized that § 36(b) was enacted "to ensure that investment advisers passed on to fund investors the savings that they realized from these economies of scale." *Migdal*, 248 F.3d at 321; *see also Kalish*, 742 F. Supp. at 1237 ("If a fund realizes economies of scale, its willingness to let the shareholders participate in the resulting benefits becomes a factor in evaluating the reasonableness of the adviser-manager's fees"). *See also* S. Rep. No. 91-184, 1970 U.S.C.C.A.N.,

supra, at 4902 ("[P]roblems arise due to the economies of scale attributable to the dramatic growth of the mutual fund industry. In some instances these economies of scale have not been shared with investors").

While fee breakpoints have been established by many funds to help compensate for economies of scale, "the fee breakpoints may fail to consider further economies of scale, as most fee schedules max out at some high asset value." Dillon, *supra*, at 298. A SEC study of the 100 largest mutual funds found that "most of the funds in the sample with management fee breakpoints had assets above the last breakpoint." Paul Roye, The Investment Management Institute, Keynote Address, *Mutual Funds and Investment Management* (2001), in 1250 PLI/Corp 11, 17 (2001). Thirty-four out of the forty-seven funds in the study that used breakpoints (72 percent) had assets that exceeded their highest breakpoint. Moreover, the combined assets in excess of these highest breakpoints totaled $318 billion, representing 37 percent of the total assets invested in those funds. SEC, DIV. INV. MGMT.: REPORT ON MUTUAL FUND FEES AND EXPENSES (2000), *available at* http://www.sec.gov/news/studies/feestudy.htm#item13.

The failure to adequately pass on to the investor the gains realized from economies of scale is further demonstrated by assessing the fees charged by investment advisors used by Vanguard. Contrary to the mutual fund industry practice, where investment firms sponsor mutual funds that are largely controlled and operated by investment

advisers, Vanguard stands alone in the industry by hiring outside advisers, called "sub-advisers," to manage its professionally-advised mutual funds. *See* Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 95. As the size of Vanguard funds increased from just $10 million to more than $25 billion, the fee charged Vanguard shareholders decreased by more than 50 percent, allowing "Vanguard's boards to capture those cost savings and pass that saving on to Vanguard's shareholders." *Id.* at 100. Conversely, when managing their own captive funds, the same sub-advisors contracted by Vanguard reduced their fees by only 10 percent over the same range in fund size. *Id.*

2. A Fairness Standard Is Needed To Compensate For The Market Failures That Are Inherent In The Mutual Fund Industry.

The Seventh Circuit's standard is also inconsistent with the congressional intent to "mitigate the competitive deficiencies of the mutual fund industry." *Gallus*, 561 F.3d at 821 (citing *Gartenberg*, 694 F.2d at 928-29). As the mutual fund industry flourished, Congress recognized the need to further protect investors from the monopolistically competitive nature of the mutual fund industry as well as the inherent conflicts of interest pervasive throughout the industry. *See Daily Income Fund, Inc.*, 464 U.S. at 536 (noting that Congress had acted based on "its concern with 'the potential for abuse inherent in the structure of investment companies'")

(quoting *Burks*, 441 U.S. at 480)). *See generally Gallus*, 561 F.3d at 821 ("Several unique features of the mutual fund industry have made it the focus of congressional regulation") (citing *Burks*, 441 U.S. at 480-81).

The *Gartenberg* court recognized that § 36(b)'s legislative history does not permit the court "to substitute its business judgment for that of a mutual fund's board of directors." 694 F.2d at 928 (quoting S. Rep. No. 91-184, 91st Cong., 2d Sess. (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4902). Thus the Seventh Circuit is correct to the extent that "Section 36(b) does not say that fees must be "reasonable" in relation to a judicially created standard." *Jones*, 527 F.3d at 632. However, the court in *Gartenberg* also noted that the Senate Report states that "a 'corporate waste' standard would be 'unduly restrictive.'" 694 F.2d at 928. *See also Daily Income Fund, Inc.*, 464 U.S. at 540 ("Congress decided not to rely solely on the fund's directors to assure *reasonable* adviser fees, notwithstanding the increased disinterestedness of the board") (emphasis added). But the Seventh Circuit's test implicitly rejects the *Gartenberg* analysis on this point, as it essentially reflects such an "unduly restrictive" waste standard and thus is inconsistent with congressional intent behind the ICA.[9] Conversely, the Eighth Circuit's standard

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[9] The Seventh Circuit assessed the amount of compensation only in the context of asking whether "compensation [may be] so unusual that a court will infer that deceit must have occurred, or that the persons responsible for decision have abdicated." *Jones*, 527 F.3d at 632.

reflects the balance between these two extreme interpretations of the breadth of the ICA's fiduciary duty. It is less restrictive than a waste standard but is also not a simple reasonableness test permitting courts to exercise their own business judgment. Instead, it is anchored in familiar common-law principles of fiduciary duty, which Congress incorporated in § 36(b). The test compares the fees paid by the fund to fees resulting from arm's length negotiations – negotiations that do not occur between fund and their advisers because of the recognized market failures that are persistent in the mutual fund industry.

IV. IN LIGHT OF MUTUAL FUND MARKET DEFICIENCIES, THE COURT SHOULD ADOPT AN INTERPRETATION OF "FIDUCIARY DUTY" THAT RECOGNIZES THE SEVENTH CIRCUIT'S CONCERN WITH DISCLOSURE OF INFORMATION WHILE CONTINUING TO PROTECT INVESTORS' INTERESTS IN INVESTMENT FEES NEGOTIATED AT ARM'S LENGTH.

The Eighth Circuit recently decided that although the *Jones* test was a sufficient condition for establishing a breach of the duty, demonstrating that an investment advisor played "tricks" or failed to make full disclosure is not a necessary condition for establishing a breach of fiduciary duty. *Gallus*, 561 F.3d 816. The court favored an approach which uses the tests of *Gartenberg* and *Jones* each as means of establishing a breach, stating that "the proper approach is one that looks to the adviser's

conduct during negotiation *and the end result*." *Id.* at 823 (emphasis added) ("The *Gartenberg* case demonstrates one way in which a fund adviser can breach its fiduciary duty; but it is not the only way").[10]

Additionally, when assessing the fairness of the fees charged by investment advisors, the court should not limit itself to "comparing the adviser's fee with the fees charged by other mutual fund advisers" as was suggested by the Seventh Circuit in *Jones*. 537 F.3d at 732 (Posner, J., dissenting from denial of rehearing en banc). The Eighth Circuit held in *Gallus* that the district court "erred in rejecting a comparison between the fees charged to Ameriprise's institutional clients and its mutual fund clients." *Gallus*, 561 F.3d at 823. In *Gallus* the court found that a "reliance on other fees throughout the industry will not satisfy § 36(b) because of the competitive defects of the mutual fund market." *Id.* at 821 (citing *Gartenberg*, 694 F.2d at 930). Limiting such a standard could potentially allow a fiduciary to evade liability by comparing a fund charging excessive fees to other funds charging excessive fees. *See Jones*, 537 F.3d at 732 (Posner, J., dissenting from denial of rehearing en banc) ("The governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide, so the

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[10] As the *Gallus* court points out, the *Gartenberg* approach alone has not been able to protect investors concerning the advisor's fee, but is one factor to consider in determining whether a fiduciary breach occurred under § 36(b). *Gallus*, 561 F.3d at 823 n.4 ("This may explain why no plaintiff has ever obtained a judgment in an action brought under that provision.").

panel's comparability approach would if widely followed allow those fees to become the industry's floor."). The comparison is particularly compelling in the case of indexed funds, because "[i]ndexing is a mechanical process that is essentially identical for pension funds and mutual funds." Freeman & Brown, *supra*, at 640 ("It is difficult to see how mutual fund investment advisors can justify advisory fees [for index funds] that are more than ten times greater than those charge for pension funds").

The *Gallus* court explained that "the argument for comparing mutual fund advisory fees with the fees charged to institutional accounts is particularly strong in this case because the investment advice may be essentially the same for both accounts." *Gallus*, 561 F.3d at 824; *see* Freeman et al., *Advisory Fees: New Evidence*, *supra*, at 150 ("Courts need to understand that in advisory fee cases, where the absence of arm's-length bargaining is the central issue, the focus belongs on free market comparators where arm's-length bargaining actually occurs and fair market values are honestly established."). In *Jones*, such a comparison also may have been warranted, especially since "[a] particular concern in this case is the adviser's charging its captive funds more than twice what it charges independent funds." 537 F.3d at 731 (Posner, J., dissenting from denial of rehearing en banc).

CONCLUSION

Because investments in mutual funds are critical to the retirement security and future educational opportunities of millions of Americans and because market failures effectively deprive investors of meaningful bargaining power to negotiate lower investment fees, the Court should overrule the decision of the Seventh Circuit. Absent the application under § 36(b) of a standard reflecting traditional common-law requirements, the laissez faire theory of regulation promoted by the Seventh Circuit allows mutual funds to avoid price competition while tens of millions of Americans fail to receive the full return on their investments. The Court should adopt a balanced test like that used by the Eighth Circuit in *Gallus*, which incorporates a fiduciary test that mimics the result of what would be achieved through arm's length negotiations.

For the foregoing reasons, the judgment of the Seventh Circuit Court of Appeals should be reversed.

Respectfully submitted,

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AMICUS CURIAE BRIEF

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Supreme Court, U.S.
FILED
JUN 15 2009
OFFICE OF THE CLERK

No. 08-586

In the Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN, PETITIONERS

v.

HARRIS ASSOCIATES, L.P.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR JOHN C. BOGLE AS AMICUS CURIAE IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Whether a shareholder's claim that a mutual fund's investment adviser charged an excessive fee to the mutual fund—more than twice the fee it charged to funds with which it was not affiliated—is not cognizable under Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. 80a-35(b), unless the shareholder can show that the adviser misled the fund's directors who approved the fee.

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Appendix C: Letter from Robert L. Augenblick, President and General Counsel, Investment Company Institute, to Hon. John E. Moss, Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Com-

merce, dated December 17, 1969, *Mutual Fund Amendments (Part I): Hearings Before the Subcomm. on Commerce & Finance of the H. Comm. on Interstate & Foreign Commerce*, 91st Cong 441..... C1

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INTEREST OF AMICUS CURIAE

Amicus John C. Bogle is a pioneer in the mutual fund industry.[1] As a recent industry reference noted, he "has led a life-long crusade as an advocate for the investor by fighting against excessive cost in asset management that erodes investors' returns." Lee Gremillion, *Mutual Fund Industry Handbook* 26 (2005).

Mr. Bogle began in 1951 with the Wellington Management Company. In 1974, he founded what is now The Vanguard Group, Inc., one of the largest mutual fund organizations in the world presently managing assets in excess of $1 trillion. He served as Chief Executive Officer of Vanguard until 1996 and is now President of Vanguard's Bogle Financial Markets Research Center. He has been recognized as one of the investment industry's four "Giants of the 20th Century" (Fortune, 1999), one of the "Financial Leaders of the 20th Century" (Macmillan Press Ltd., 1997), and as one of "The Time 100—the world's 100 most powerful and influential people" (Time 2004). He served as a Member (1969-1974) and Chairman (1969-1970) of the Board of Governors of the Investment Company Institute—the mutual fund industry trade association—at the time Section 36(b) of the Investment Company Act was under consideration by Congress. A list of Mr. Bogle's institutional affiliations and professional memberships, honorary degrees,

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[1] The parties have consented to the filing of this brief. No counsel for a party authored this brief in whole or in part, and no counsel for a party or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than amicus curiae or his counsel made a monetary contribution to its preparation or submission.

awards, and publications is included in Appendix A to this brief.

As a close observer and participant in the mutual fund industry, Mr. Bogle has pioneered investment vehicles—such as index funds—that have made available sound, low-cost investment options to the general public. He has also consistently spoken out on the legal and ethical duties owed by investment industry professionals to those whose money is entrusted to their care. In his speeches and writings, he has often drawn attention to the potential and actual conflicts between the business interests of those who manage mutual funds and the fiduciary duty they owe to fund shareholders. The court of appeals in this case found reasons to disregard those conflicts and instead dilute the fiduciary duties imposed by Section 36(b). Mr. Bogle submits this brief in the hopes that his experience and perspectives will assist the Court in understanding the problems that Congress intended to solve in Section 36(b) and the even-greater need for robust enforcement of Section 36(b) in today's mutual-fund marketplace.

SUMMARY OF ARGUMENT

Section 36(b) imposes a "fiduciary duty with respect to the receipt of compensation" on investment advisers to mutual funds. 18 U.S.C. 80a-35(b). At its core, a fiduciary duty requires that the fiduciary act not in its own interests, but in the interests of those to whom the duty is owed. This case presents the question whether, notwithstanding that duty, an investment adviser to captive mutual funds may simply take as much compensation as it can get, with no regard for the interests of the fund shareholders to whom the adviser's fiduciary

duty is owed. The court of appeals held that an investment adviser could do so. Its decision should be reversed.

I. Mutual funds differ dramatically from most business organizations. Most funds are "externally managed," *i.e.*, they have little or no personnel or facilities, and substantially all of their activities are carried on by their investment adviser. That creates an inherent conflict of interest, since the adviser is responsible to its own board and shareholders—not to the board and shareholders of the fund. The conflict is particularly grave when it comes to the adviser's compensation, since the adviser's interest is naturally in maximizing its compensation, while the fund's shareholders benefit from minimizing it. In negotiations over compensation, the fund's board (if it were inclined to try to strike a hard bargain) does not have available the key option that is ordinarily available to a firm that wants to contract for goods or services: finding another contracting partner if the price asked is too high. And in any event, the dominance of a captive fund by its adviser gives the fund board little incentive to attempt to negotiate a hard bargain on behalf of fund shareholders. The result is excessive fees paid to advisers for selecting the fund's securities. The structure of the relationship fails to protect the interests of fund shareholders.

It became increasingly clear as assets of mutual funds and the amount of their advisers' fees burgeoned in the 1950s and 1960s that the problem of adviser compensation was worsening. Studies of the industry by the Wharton School and the SEC found that advisers often charged their captive funds excessive fees, far higher than the same advisers charged independent clients for similar services. Based on those studies and its own

examination, Congress was profoundly skeptical that "bargaining" between an adviser and its captive fund would produce fair fees.

II. Congress imposed a "fiduciary duty" on advisers in Section 36(b). The court of appeals disregarded the fact that a fiduciary dealing with those to whom it owes its duty—as is the adviser in negotiating a fee with a captive fund—has always been understood to have obligations of both disclosure and fairness. Accordingly, the "fiduciary duty" of Section 36(b) requires advisers themselves not merely to make full disclosure, but also to ensure that their fees are substantively fair.

The history of Section 36(b) dramatically confirms that conclusion. Section 36(b) was drafted, at Congress's request, by the SEC and the Investment Company Institute. Both the SEC and the industry agreed in substance that the new duty is breached in the event of "an unreasonable or excessive charge" (SEC) or where the adviser has "overreach[ed] in the amount of his fee" (the Institute). That understanding was correct then, it was accepted by Congress, and there is no basis to alter it now. Moreover, the court of appeals' conclusion that an adviser can take as large a fee as it can get is inconsistent with the purposes of Section 36(b).

III. An adviser's fees satisfy its fiduciary obligation to ensure fairness if they are comparable to fees that would have been negotiated in an arm's-length transaction. The most direct way to establish that fact is to examine fees for similar services that *have* been negotiated at arm's length between independent companies. In this case, evidence bearing on that inquiry is particularly strong, since, based on the summary judgment record, respondent charged its captive funds advisory

fees that were more than twice as high in percentage terms (and in at least one case *more than 42 times as high in dollar terms*) as it charged for similar services to independent clients. But even when such clear evidence is not available, evidence of other arm's-length transactions for investment advisory services will often be the most probative.

In concluding that Section 36(b) imposes no restriction on the amount of fees that an adviser can charge, the court of appeals relied on its view that competition among funds for customers will hold the fee rates that an adviser charges its captive funds in check. Even if the court's one-sided view of that highly disputed factual issue were correct, it would not justify the court's conclusion. The duties imposed by Section 36(b) were established by Congress in 1970, and the court of appeals had no authority to vary them in accordance with its (disputed) views on the need for such duties in the current mutual fund marketplace.

In any event, the court's view is mistaken. The explosive growth in mutual fund assets has only exacerbated the problems about which Congress was most concerned—conflicting loyalties of investment advisers, the failure of advisers who are paid on a percentage of assets to share the enormous economies of scale that exist in fund management with fund shareholders, and advisers that charge captive mutual funds much higher fees for the same services than are charged to independent clients.

ARGUMENT

I. SECTION 36(b) IS BASED ON THE PREMISE THAT THERE ARE INHERENT STRUCTURAL CONFLICTS THAT JUSTIFY SKEPTICISM ABOUT WHETHER INVESTMENT ADVISERS' FEES ARE FAIR TO FUNDS AND SHAREHOLDERS

A. The Structure Of Externally Managed Mutual Funds Creates Inherent Conflicts Of Interest

1. "A mutual fund is a pool of assets, consisting primarily of portfolio securities, and belonging to the individual investors holding shares in the fund." *Burks v. Lasker*, 441 U.S. 471, 480 (1979). Mutual funds are "open-ended," *i.e.*, they "sell new shares to investors wanting to invest money, or redeem shares from investors wanting their money back, at a price dependent on the net asset value . . . of the fund." Lee Gremillion, *Mutual Fund Industry Handbook* 5 (2005).

2. Though mutual funds are organized as corporations or similar entities, with shareholders and boards of directors, the management of mutual funds differs dramatically from that of most business corporations. Other business corporations manage themselves internally; they maintain their own personnel, physical facilities, and logistical support as necessary to carry on their functions. While they may hire other firms to provide goods or perform services, they do so in arm's-length transactions, hoping to obtain the most favorable combination of price and quality that will maximize their shareholders' profits.

"Unlike most corporations, an investment company is typically created and managed by a pre-existing external organization known as an investment adviser." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984); see S. Rep. No. 91-184 (1969) (*Senate Report*). "The advisers select the funds' investments and operate their businesses." *Burks*, 441 U.S. at 481 (quoting *Senate Report* 5). Most mutual funds "have shareholders, directors, assets (cash and securities) and contracts, and not much else." *Mutual Fund Industry Handbook* 9. They have essentially no internal ability to manage their own operations.[2]

3. The adviser's dominant role has a major effect on its captive mutual funds. "Because of the unique structure [of mutual funds] the relationship between mutual funds and their investment adviser is not the same as that usually existing between buyers and sellers or in conventional corporate relationships." *Senate Report* 5. The most important difference is that, although a mutual fund's board does in principle have the option of hiring its own staff and negotiating contracts at arm's-length

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[2] See Robert Pozen, *The Mutual Fund Business* 22 (2008). Commentators routinely note the unique qualities of—and potential for conflicts inherent in—the organization of mutual funds. See, *e.g.*, Donald Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 Wash. U. L. Q. 1017, 1020, 1031-1032 (2005); Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and* Gartenberg *at Twenty-Five*, 61 Vand. L. Rev. 497, 502-505 (2008). Mr. Bogle himself has written extensively on the subject. See, *e.g.*, John C. Bogle, *A New Order of Things: Bringing Mutuality to the "Mutual" Fund*, 43 Wake Forest L. Rev. 1089 (2008); John C. Bogle, *Re-Mutualizing the Mutual Fund Industry—the Alpha and the Omega*, 45 B.C. L. Rev. 391, 391-392, 398-400 (2004).

for investment advice and other services from independent entities, in practice that option is nonexistent. With one exception—the Vanguard family of funds, founded under Mr. Bogle's leadership[3]—fund boards have virtually never attempted to replace their investment adviser with another firm. Even if the boards of captive mutual funds were inclined to negotiate hard with their investment advisers on the terms of the investment advisory contract, the ultimate threat of withdrawing the fund's business and bringing it to a competitor is thus simply not present. See, *e.g.*, *Senate Report* 5 (contrasting "the mutual fund industry, where . . . marketplace forces are not likely to operate effectively," with ordinary contexts in which "the protections of arm's-length bargaining are present").

4. In addition to the general dominance of fund boards by investment advisers and the inability of boards

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[3] The Vanguard funds became independent, with arm's-length relationships with their suppliers of services and advisers, in a series of steps, beginning in the mid-1970s. See Bogle, 45 B.C. L. Rev. at 398-407. In approving the final step in the series, the SEC concluded that the Vanguard arrangement "furthers the Act's objectives" by ensuring that the fund directors "are better able to evaluate the quality of" the services provided to the funds and by "enhanc[ing] the Funds' independence, permitting them to change investment advisers more readily as conditions may dictate." *The Vanguard Group, Inc.*, 22 S.E.C. Docket 238, 1981 WL 36522, at *14 (1981); see *id.* at *5 ("Increased independence from its adviser gives each fund much greater flexibility in negotiating advisory fees.") The Vanguard funds have continued to operate in this way, with internal management. Its individual mutual funds are co-owners of the Vanguard Group, the central entity that provides the individual funds with administrative, distribution, and, in some cases, portfolio management services. Despite the enormous growth of Vanguard, no other of the thousands of mutual funds now in existence has followed its lead. See *Mutual Fund Industry Handbook* 10.

(if they were so inclined) to employ the ultimate bargaining threat of finding another adviser, there are other factors in the structure of externally managed funds that limit the normal incentives that tend to keep a corporation aligned with the interests of its shareholders. The "insiders" who actually manage a fund are usually employees of the investment adviser, not the fund; insofar as stock options and similar arrangements help to align the insiders' interests with anyone, it is with the adviser, not the fund. As for the adviser itself, its compensation is ordinarily determined as a percentage of assets under management, which it therefore wants to see grow; the growth of assets may or may not benefit shareholders, depending on the extent to which it comes from new investments or from better performance. Mutual fund directors are ordinarily paid in cash, not shares in the mutual fund that would align their interests with shareholders. See, *e.g.*,Langevoort, 83 Wash. U. L. Q. at 1031-1032.

In addition, because ownership of a fund's shares is ordinarily very widely dispersed and because there is no "market" for control of a fund's board, unseating directors is even harder than is the case with ordinary corporations. The threat that a director whom the adviser approves would be ousted is thus vanishingly small. Finally, it is relatively easy for advisers to seat directors who are not "interested" within the meaning of the 1940 Act, see 15 U.S.C. 80a-2(a)(19), but who nonetheless are sympathetic to the adviser. See Johnson, 61 Vand. L. Rev. at 513-514; *id.* at 521-527. Congress's skepticism of the ability of fund boards to control advisers' compensation was well-founded.

B. Section 36(b) Grew Out Of The Wharton And SEC Studies, Which Brought The Problem Of High Advisory Fees, Caused By The Absence Of Arm's-Length Bargaining, To The Attention Of Congress

1. Congress originally provided for special regulation of investment companies in 1940 because of the "potential for abuse inherent in the structure of investment companies." *Burks*, 441 U.S. at 480. See Investment Company Act of 1940, 15 U.S.C. 80a-1(b).[4] The remedies Congress adopted in the 1940 Act were primarily structural ones, such as limiting the number of fund directors who could be affiliated with the adviser, 15 U.S.C. 80a-10, and requiring that fees for advice be governed by written contracts, which had to be approved initially by the shareholders and then annually by the shareholders or the board of the mutual fund, 15 U.S.C. 80a-15(a).

2. In the succeeding years, "investment companies enjoyed enormous growth, prompting a number of studies" commissioned by or undertaken by the SEC "of the effectiveness of the Act in protecting investors." *Daily Income Fund*, 464 U.S. at 537. Among those studies was a 1962 empirical study based on data from 156 funds; the study was commissioned by the SEC from the Wharton School and transmitted to Congress. *A Study of Mutual Funds*, H.R. Rep. No. 87-2274 (1962) (*Wharton Study*). The SEC then undertook its own study of mutual fund growth "to test the conclusions of the Wharton . . . Report[] by an intensive firsthand examination of a cross

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[4] Although the dominant form of investment company was originally the closed-end fund, mutual funds had more assets than closed-end funds by 1943, and their dominance has increased ever since. See *Mutual Fund Industry Handbook* 16, 21.

section of the investment company industry." *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 89-2337 (1966) (*SEC Study*). As relevant here, the two studies focused on the weakness of the position of externally managed mutual fund boards in controlling fees charged by investment advisers, which, "as a fund's assets grew, . . . could produce unreasonable fees in light of the economies of scale realized in managing a larger portfolio." *Daily Income Fund*, 464 U.S. at 537.

Both studies agreed on the basic nature of the problem. As the SEC concluded:

> The ability of unaffiliated directors to bargain at arm's length is seriously hampered because they are seldom free as a practical matter to terminate a long established management relationship solely because of differences over fee rates. Under these circumstances, the essential element of arm's length bargaining—the freedom to terminate negotiations and to bargain with other parties—is lacking.

SEC Study 12; see *id.* at 45-49, 74-75; *Wharton Study* xiii. Indeed, "even a requirement that all of the directors of an externally managed investment company be persons unaffiliated with the company's adviser-underwriter would not be an effective check on advisory fees and other forms of management compensation." *SEC Study* 148; see *Daily Income Fund*, 464 U.S. at 540-541.

The studies also noted that the problem had been exacerbated by the substantial growth of mutual funds and the failure meaningfully to share the resulting economies of scale with investors. The SEC explained that "increases in an investment company's assets do not lead to commensurate increases in the cost of furnishing it

with investment advice." *SEC Study* 10; see *id.* at 94-96. Yet, "[b]ecause of the absence of competition, the limitations of disclosure, the ineffectiveness of shareholder voting rights and the difficulty of effective action by unaffiliated directors, *advisory fee rates did not decline as the funds grew.*" *Id.* at 12 (emphasis added); see *id.* at 125-132, 149; *Wharton Study* xii, 490.[5]

Finally, the studies concluded that "externally managed mutual funds pay substantially higher advisory fee rates than . . . companies which are operated exclusively as equity investment vehicles for banks and other institutions"; such advisory fees "also are substantially higher for comparable asset levels than the rates that private individuals pay for investment advice"; and "the higher management expenses of the externally managed funds cannot be attributed solely to cost factors." *SEC Study* 11; see *id.* at 102-114, 114-121, 121-125; see also *Wharton Study* xii-xiii, 34, 492-495.

3. As a result of those studies and the recommendations of the SEC, Congress amended the Act in 1970. One change was to provide in Section 15(c) that fund directors had a "duty . . . to request and evaluate," and

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[5] It is important to distinguish between the already-high *rates* (as a percentage of assets) that advisers charge and the even more excessive dollar *amounts* that are produced by those fee rates. It was the huge increase in mutual fund assets and, therefore, the amount of mutual fund fees, that concerned the SEC in 1966, since the cost of providing advisory services (essentially, managing an investment portfolio) rises far more slowly than the fees generated by taking a percentage of the increase in assets. Yet courts have generally acceded to the advisers' desire to frame any debate about fees in percentage—not dollar—terms, thereby giving advisers a license to charge fees that are unjustifiable under any standard. See John C. Bogle, *The Battle for the Soul of Capitalism* 155-157, 198 (2005).

investment advisers had a "duty . . . to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser" to a fund. 15 U.S.C. 80a-15(c). That duty ensured that, insofar as fund board members were inclined and able to police excessive fees, they would have the necessary information to do so. Another change required annual approval of contracts with investment advisers by fund directors who were not "interested persons," *i.e.*, affiliated with the investment adviser, in addition to the annual approval by the board as a whole or the shareholders. 15 U.S.C. 80a-15(c).

"In contrast to its approach in other aspects of the 1970 amendments," however, Congress chose in Section 36(b) "not to rely solely on the fund's directors to assure reasonable adviser fees." *Daily Income Fund*, 464 U.S. at 540; see *Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 108 (1991). Accordingly, Section 36(b) provides that "the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services" paid by an investment company. 18 U.S.C. 80a-35(b). It further provides for an express private right of action by a security holder of an investment company against the adviser "for breach of fiduciary duty in respect of such compensation." *Ibid.* Congress considered the industry's desires as well: It provided that the plaintiff has the burden of proving breach of fiduciary duty, 15 U.S.C. 80a-35(b)(1), and that the plaintiff may recover damages limited to the amount of compensation or payments received only for a "look back" period beginning one year before the action was instituted, 15 U.S.C. 80a-35(b)(3). See also 15 U.S.C. 80a-35(b)(6) (finding of breach of fiduciary duty may not

be basis for a finding of a violation of certain other provisions or for an injunction prohibiting a person from serving as an investment adviser or officer of a fund).

Before Section 36(b), there had been suits by investors challenging excessive fees. Because the fund board had approved the compensation, the plaintiffs' claims had been analyzed "according to common law standards of corporate waste, under which an unreasonable or unfair fee might be approved unless the court deemed it 'unconscionable' or 'shocking'," or the plaintiffs could prove "gross abuse of trust." *Daily Income Fund*, 464 U.S. at 540 n.12. Congress cut loose the new cause of action in Section 36(b) from a "waste" standard by providing that "approval by the board of directions of [the] investment company of [the advisers'] compensation . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. 80a-35(b)(2).

II. SECTION 36(b) REQUIRES THE ADVISER TO ENSURE FULL DISCLOSURE *AND* SUBSTANTIVE FAIRNESS

A. The Text Of Section 36(b) Requires Full Disclosure And Substantive Fairness

This Court has explained that "[t]he fiduciary duty imposed on advisers by § 36(b) is owed to the company itself *as well as its shareholders*." *Daily Income Fund*, 464 U.S. at 535 n.11 (emphasis added); see *id.* at 541 n.12. Under the 1940 Act, an adviser *must* obtain annual approval of its compensation from the fund board or its shareholders—*i.e.*, those to whom it owes its duty of loyalty. 15 U.S.C. 80a-15(a) and (c). Thus, an investment

adviser when dealing with the issue of compensation is annually in the position of a fiduciary dealing with those to whom the fiduciary owes its duty—*i.e.*, the "beneficiaries."

A fiduciary, "[w]hether acting in a fiduciary or personal capacity, . . . has a duty in dealing with a beneficiary *to deal fairly* and to communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter." Restatement (Third) of Trusts § 78(3) (2001) (emphasis added); see also *id.* cmt. g (trustee "must be able to show that the dealings were fair"). Fair dealing, in addition to full disclosure, are required. See Bogert & Bogert, *The Law of Trusts and Trustees* § 976 (rev. 2d ed. 1993) ("If the beneficiaries are of full age and sound mind, they may enter into a valid agreement with the trustee as to the trustee's compensation, provided the trustee displayed the utmost good faith and fairness in the transaction.") (footnotes omitted). That duty of fair dealing applies specifically to a fiduciary's dealings regarding compensation. See Restatement, *supra*, § 38 cmt. f; see also *id.* § 78(2) cmt. c(4).

The court of appeals' conclusion that an investment adviser may take as much compensation as it can get was based on the view that "when the settlor or persons charged with [a] trust's administration make a decision [on compensation], it is conclusive." Pet. App. 9a. That principle, however, has no application here, where the fiduciary is not dealing with anyone in the role of a *settlor*, who after all owns a trust's assets before the trust is created, but rather with those in the role of *beneficiaries* whom the fiduciary is supposed to be pro-

tecting.[6] The court entirely disregarded that fundamental point.

B. The SEC And The Industry, Which Jointly Drafted Section 36(b), Told Congress That It Required Compensation To Be Substantively Fair

The 1966 SEC report recommended that Congress require that fees charged by investment advisers be "reasonable." *SEC Study* 143-149. That standard, however, was not ultimately employed in Section 36(b). Instead, the terms of Section 36(b) were drafted jointly by the SEC and the Investment Company Institute (of which Mr. Bogle was at the time the Chairman). When the SEC and the Institute were asked what the "fiduciary duty" standard in Section 36(b) meant, they *agreed, in formal memoranda submitted to Congress, that it imposed a substantive limit on fees.*[7]

1. The Senate initially passed the bill including Section 36(b)'s new "fiduciary duty" language. See 115 Cong. Rec. 13,700 (1969). Then, at a hearing of the House subcommittee considering the bill, the SEC representative was asked about the differences between the

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[6] Even when a settlor of a trust sets the compensation for a fiduciary, it is not "conclusive." "If the amount of compensation provided by the terms of the trust is or becomes unreasonably high or unreasonably low, the court may allow a smaller or larger compensation." Restatement, *supra*, § 38 cmt. e. And the adviser's dominant role and influence over a captive fund would also require the adviser to demonstrate the utmost fairness when negotiating compensation with the fund.

[7] It is not surprising that the SEC agreed with the fiduciary duty standard, since it had originally proposed the "reasonableness" standard on the ground that it captured what a fiduciary's obligations are in these circumstances. See, *e.g.*, *SEC Study* 143-144.

earlier "reasonableness" standard and the new "fiduciary duty" standard. The SEC submitted its views on the new bill in a formal memorandum, which is reprinted as Appendix B to this brief.

The memorandum stated that "[t]he short answer to the question . . . is that there is little substantive difference between the standard of reasonableness and the standard of breach of fiduciary duty." *Mutual Fund Amendments (Part I): Hearings Before the Subcomm. on Commerce & Finance of the H. Comm. on Interstate & Foreign Commerce*, 91st Cong. 189 (1969) (*House Hearings*). The Commission explained that "[u]nder the new language, a breach of fiduciary duty occurs when a fiduciary permits an unreasonable or excessive charge to be levied on the fund." *Ibid.* Because the "shift in language from 'reasonableness' to 'fiduciary duty'" had primarily the effect of "shift[ing] the focus of any litigation . . . from the directors of the fund to the investment adviser," it was "primarily procedural not substantive." *Id.* at 190. "It was designed to assure reasonable fees just as the original language . . . was meant to do." *Ibid.*; see also *ibid.* ("[A] breach of fiduciary duty . . . would occur when compensation to the adviser for his services is excessive in view of the services rendered—where the fund pays what is an unfair fee under the circumstances.").

2. The Investment Company Institute confirmed that understanding. It, too, sent the committee a letter, reprinted as Appendix C, *infra*. While the Institute was understandably more laconic when discussing the substance of the standard, the Institute was quite clear that the "fiduciary duty" standard precludes an unreasonable fee:

> Many words have been used in attempting to describe how far a fiduciary may go in negotiating his fee without violating his fiduciary relationship. *A good way to put it is that he may not overreach in the amount of his fee even though the other party to the transaction, in full possession of all the facts, does not believe the fee is excessive.*

House Hearings 441 (emphasis added).

3. Finally, this understanding of the "fiduciary duty" principle is further confirmed by a statement that Congs. Dingell, Adams, and Eckhardt added to the report of the House committee. They objected to the committee's addition to Section 36(b) of a provision (later dropped from the final bill) requiring plaintiffs to prove a breach of fiduciary duty by "clear and convincing" evidence. See H.R. Rep. No. 91-1382 168. They made plain that they understood the "fiduciary duty" standard of Section 36(b) exactly as had the SEC and the industry. See, *e.g.*, *id.* at 201 ("In testing whether or not a fiduciary duty has been breached *by virtue of an inordinately high level of compensation* for services of an investment adviser . . . , it is necessary under the terms of the bill as reported for the stockholder complaining *of the high level of compensation* to prove 'a breach of fiduciary duty *by clear and convincing evidence.*'") (first two emphases added).

C. Permitting The Adviser To Take As Much As It Can Get Is Inconsistent With The Purposes Of Section 36(b)

1. The court of appeals' holding that the adviser can take as much compensation as it can get gives the industry that which it was unable to obtain when the bill was being considered, and deprives the investing public of precisely the protection that *everyone involved* believed

the bill would provide. It would also render Section 36(b)'s imposition of a fiduciary duty standard on advisers essentially superfluous. In 1970, Congress amended Section 15(c) to provide that fund directors had a duty to request, and investment advisers had a "duty . . . to furnish, such information as may reasonably be necessary to evaluate the terms of any contract" for the adviser. 15 U.S.C. 80a-15(c). Insofar as the "fiduciary duty" standard of Section 36(b) merely imposed a duty to "make full disclosure and play no tricks" on investment advisers, as the court of appeals held, Pet. App. 8a, it would thus be redundant of the obligation Congress added to Section 15(c). The "fiduciary duty" standard of Section 36(b) avoids redundancy, and justifies the very substantial attention Congress paid to it, only because it imposes an added, substantive duty on the adviser to ensure not only that facts relating to its fees are fully disclosed (as required in any event by Section 15(c)), but also that the fees are fair. See, e.g., *Duncan v. Walker*, 533 U.S. 167, 174 (2001) ("It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant.") (internal quotation marks omitted).

2. The court of appeals fundamentally departed from Congress's purposes in enacting Section 36(b) when it held that the adviser/fiduciary can take as much compensation as it can get, with no concern for the interests of the fund and its shareholders. As this Court has explained, Congress was concerned in 1970 that the state-law standard of "corporate waste" that had previously governed shareholder suits charging excessive fees was "inadequate to ensure reasonable adviser fees." *Daily Income Fund*, 464 U.S. at 534 n.10. The court of appeals'

elimination of *all* substantive review under Section 36(b) would obviously be even more inadequate, since it would completely eliminate the obligation to ensure reasonable fees—even in cases in which corporate waste could be proven. See *id.* at 540 (noting that Congress in 1970 "decided not to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of the board").

3. More fundamentally, the court of appeals' holding would essentially convert Section 36(b) into an anti-fraud statute, requiring only that investment advisers make full disclosure and avoid dishonesty. Congress, however, chose to impose on investment advisers a fiduciary duty—a far more stringent duty than was imposed by already existing antifraud prohibitions elsewhere in the securities laws. See, *e.g.*, 15 U.S.C. 80b-6; 15 U.S.C. 77q; 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5. Under then-Judge Cardozo's classic statement of fiduciary duty,

> [a] trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. . . . Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.

Meinhard v. Salmon, 164 N.E. 545, 546 (1928). The court of appeals' reduction of that most stringent obligation to the commonplace duty to avoid dishonesty is profoundly at odds with the language, history, and purposes of Section 36(b).

III. THE COURT OF APPEALS' VIEW THAT COMPETITION AMONG FUNDS KEEPS ADVISORY FEES IN CHECK, EVEN IF CORRECT, COULD NOT ALTER THE FIDUCIARY OBLIGATIONS OF INVESTMENT ADVISERS UNDER SECTION 36(b)

A. Section 36(b) Requires An Inquiry Into Whether Advisory Fees Are Comparable To What Would Have Been Negotiated In An Arm's-Length Transaction

1. The court of appeals in this case rejected the Second Circuit's holding in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982), that "the test [under Section 36(b)] is essentially whether the fee schedule represents a charge within the range of what would have been negotiated at arm's-length in the light of all of the surrounding circumstances." That arm's-length standard is consistent with Section 36(b), which at bottom is based on profound skepticism that transactions between investment advisers and captive funds are arm's-length, and therefore substantively fair, transactions.[8]

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[8] *Gartenberg* also, without explanation, used the distinct formulation that the adviser violates Section 36(b) if it "charge[s] a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's length bargaining." 694 F.2d at 928. The duties that a fiduciary owes, however, are more rigorous. Insofar as this alternative formulation suggests that an investment adviser/fiduciary may take advantage of its position at the expense of those to whom it owes its obligation, so long as the adviser does not go too far in doing so, it is incompatible with any accepted account of fiduciary duty. The relative inability of Section 36(b) to control excessive fees to date is due in part to courts

The arm's-length standard also follows from the fiduciary principles discussed above. The core duty of a fiduciary is "to act for the benefit of the other as to matters within the scope of the relationship." Restatement, *supra*, § 2 cmt. b. The fund and its shareholders receive all the benefit they reasonably could expect if they obtain the fiduciary's services at a price comparable to the price that would have been charged in an arm's-length, marketplace transaction. The fiduciary, too, who is permitted "reasonable" compensation, see Restatement *supra*, § 78(2) cmt. c(4), has received all that it is entitled to expect.

2. *Gartenberg* discussed some ways of proving whether an adviser's compensation is consistent with Section 36(b). See 694 F.2d at 930. *Gartenberg* correctly questioned the probative value of a comparison of an adviser's fee to fees that other advisers of externally managed funds charged their own captive mutual fund. *Id.* at 929. As Judge Posner explained, "[t]he governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide," such that the comparison "would . . . allow those fees to become the industry's floor." Pet. App. 41a; accord *Gallus v. Ameriprise Financial, Inc.*, 561 F.3d 816, 823 (8th Cir. 2009) ("[T]he standard that the Second Circuit enunciated should not be construed to create a safe harbor of exorbitance, for under such a view an adviser's fiduciary duty would be diluted to a simple and easily satisfiable requirement not to charge a fee that is egregiously out of line with industry norms."). The premise of Section 36(b) is skepticism that compensation deals between advisers and their

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using this incorrect formulation instead of the "arm-s-length transaction" standard that captures far better the duty that a fiduciary owes.

captive funds are arm's-length transactions. Such transactions cannot provide a benchmark for what Section 36(b) requires of a fiduciary.

Gartenberg discussed factors that could be useful in proving excessive fees, such as the adviser's "cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager." 694 F.2d at 930. Most of those factors are ultimately designed to compare the adviser's costs with the fees it obtains from the fund. Such a cost-based test, though no doubt useful in some cases, relies on a series of highly contestable facts that are in general under the adviser's unique control and unavailable to shareholders. Cf. *Senate Report* 6 ("Nothing in the bill is intended . . . to suggest that a 'cost-plus' type of contract would be required."). It also relies on rather subjective qualitative judgments ("the nature and quality of the service") that are extraordinarily difficult to evaluate. See John P. Freeman, Stewart L. Brown, & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 130-139 (2008) (*Freeman/Brown/Pomerantz*).

4. There are better approaches. The most direct and probative evidence of whether the adviser is violating its fiduciary duty by charging an excessive fee (in percentages or, even better, in dollars) is likely to be based not on the adviser's costs, but on an examination of arm's-length transactions involving the sale of essentially identical advisory services in the marketplace, where arm's-length bargaining over investment advisory services regularly occurs. From the beginning, the concerns that triggered Section 36(b) have centered on investment

advisers that charged high fee rates (and even higher fee *amounts*) to their captive mutual funds and much lower fee rates (and amounts) to pension plans and others who were in a position to bargain for the best quality investment advice at the best price. See *Daily Income Fund*, 464 U.S. at 537. As the Eighth Circuit recently held in *Gallus*, when the services rendered by the adviser to a captive fund and to an independent pension fund or other institutional investor are genuinely comparable (even if not exactly the same), that kind of comparison is probative on the question whether the adviser has satisfied its Section 36(b) fiduciary duty. 561 F.3d at 824.[9]

Indeed, it is difficult to imagine a clearer violation of an adviser's fiduciary duty than when the adviser charges its captive fund more than others for similar (or lesser) services. In such cases the difference in fee is likely to reflect either an improperly excessive fee charged to the fund or the forbidden appropriation by the adviser/fiduciary of value from the fund and use of that value to enrich itself in its dealings with third parties. Either would be a violation of the adviser's fiduciary duty under Section 36(b).

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[9] In *Gartenberg*, the court held that the "arm's-length transaction" inquiry is not advanced by comparing the defendant's fees for providing investment advice to a money market fund to "fees charged by investment advisers to large pension funds." 694 F.2d at 930 n.3. The court relied on the fact that the "nature and extent of services required" by the money market fund, which had to deal with a "myriad of daily purchases and redemptions," "differ[ed] sharply" from the services required by a large pension fund that did not provide those services. *Ibid.* *Gartenberg* did not reject the general proposition that apples-to-apples comparisons between a defendant's fees and those actually charged in comparable arm's-length transactions can be highly probative under Section 36(b).

Comparisons with other arm's-length transactions can also be highly probative, especially in cases in which the investment adviser (unlike respondent) does not have comparable independent clients to which it supplies advice. It would thus be probative to compare the fee charged by a given investment adviser/defendant to its captive fund with fees charged by *other* investment advisers to their independent clients, so long as the advisory services provided in the two cases are comparable. Similarly, the internally managed funds (today, primarily Vanguard funds, see note 3, *supra*) that retain outside investment advisers do so in arm's-length transactions, since an internally managed fund faces no conflict in negotiating the most favorable terms it can get from the investment adviser. The prices paid by such funds accordingly provide another probative benchmark of arm's-length transactions.

In short, the most probative evidence of what would have been negotiated in an arm's-length transaction will often be the evidence of actual similar arm's-length transactions. This is not primarily a litigation issue. Fund boards should ask for such information under Section 15(c) when considering adviser compensation, and advisers should in any event furnish it under both Section 15(c) and Section 36(b). But the issue will arise in litigation as well, and, when it does, data concerning fees paid in comparable arm's-length transactions is likely the most probative.

B. The Court Of Appeals' Reliance On Its Disputed View Of The Present Effect Of Competition In The Industry Was Legally Faulty And Factually Incorrect

1. In reaching its conclusion that an investment adviser/fiduciary under Section 36(b) need only "make full disclosure and play no tricks," Pet. App. 8a, the court of appeals relied in substantial part on its view that competition among mutual funds for customers operates to keep advisory fees at a fair level. See Pet. App. 11a-13a. As a matter of law, the court's reliance on that disputed factual premise was mistaken. Because Congress in 1970 imposed a duty on investment advisers not merely to make full disclosure, but also to deal fairly with the funds and shareholders to whom they owe their obligation, that obligation remains today. Current market conditions cannot justify eliminating the fair dealing obligation.

2. The court of appeals relied on one source in concluding that investment advisory fees generally are held to competitive levels—even though, as the court of appeals conceded, "investment advisers create mutual funds, which they dominate" and "mutual funds are 'captives' of investment advisers." Pet. App. 6a, 7a; see Pet. App. 12a (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151 (2007) (*Coates/Hubbard*)). Other sources, discussed below, come to the opposite conclusion: that the problems of excessive fees and inadequate controls on compensation in the mutual fund industry have, if anything, become worse since the Wharton and SEC studies of the 1960s, as the assets under management at mutual funds (and the amount of the fees paid) have skyrocketed.

This Court need not resolve this essentially factual dispute. Coates and Hubbard claim that because of competition among funds for investors, market incentives require mutual funds generally to keep their fees to a competitive level. If that is correct, then advisory fees paid by funds will be justifiable under Section 36(b). But if Coates and Hubbard are wrong, then the court of appeals' rule would remove the only constraint that keeps advisory fees from going even higher than their already excessive levels, to the substantial detriment of this nation's investors. Either way, there would be no basis to relax the Section 36(b) "fiduciary duty" standard.

3. In any event, the court of appeals' view is mistaken; the conditions outlined in the Wharton and SEC studies that provided the impetus for Section 36(b) have become even more troubling today. Fund costs (including advisory fees), while sometimes measured in fractions of a percent, have an enormous effect on the ability of investors over long periods of time to keep pace with the market and achieve their investment objectives. See, *e.g.*, *The Battle for the Soul of Capitalism* 159-168 (illustrating the huge impact of fund costs generally on investment returns). It is exceptionally important that this Court retain the protection for investors that Congress built into Section 36(b).

4. a. A study published in 2001 specifically compared the investment advisory fees paid by mutual funds, on the one hand, and those paid by pension funds and by an internally managed fund family (Vanguard), on the other. See John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. Corp. L. 609, 627-640 (2001) (*Freeman/Brown*). The study compared actively managed mutual funds with pension funds, *id.* at 627-637, and actively managed

mutual funds with Vanguard funds that get investment advice from outside firms, *id.* at 637-639. It also compared S&P 500 index mutual funds with pension funds that follow the same index strategy and with the costs that Vanguard's similar fund incurs for investment advice from the Vanguard Group, which provides the advice at cost. *Id.* at 639-640. In each case, externally managed mutual funds were paying substantially more for investment advice than were the pension funds and the Vanguard funds.[10]

Moreover, an adviser's captive mutual funds not only are frequently charged larger percentage fees, but also, because they frequently have larger assets, are charged even more in dollar terms. For example, on the summary judgment record in this case, respondent charged

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[10] For example, on average actively managed large-cap equity mutual funds paid 52 basis points for investment advice, while large-cap pension funds paid 21 basis points. *Freeman/Brown*, 635. The difference in dollars is even greater, because the mutual funds on average had much larger assets ($2,068 million) than the pension fund clients ($555 million). *Ibid.* In addition, six firms that provided advice to both captive mutual funds and pension funds charged their captive funds an average of 54 basis points, while they charged pension fund clients 23 basis points. *Id.* at 636. One adviser charged its captive mutual funds 4.5 times more in basis points (84 basis points versus 18 basis points) than it charged its pension customers. *Ibid.* The difference was *more than 14 times as great* in dollar terms—$20.644 million for the captive funds (84 basis points times $24,577 million in assets) versus $1.4 million (18 basis points times $7,817 million in assets) for the pension funds. *Ibid.* Indeed, perhaps the most striking results were provided by the S&P 500 index funds, which in fact require very little investment advice. While mutual funds examined in this category paid either 16 or 20 basis points for investment advice (depending on the universe examined), pension funds paid 1.4 basis point, and Vanguard's fund paid .01 (not a misprint) basis point to the parent Vanguard Group. *Id.* at 640.

one of its captive mutual funds (Equity & Income) an effective rate of 73 basis points for investment advice, while it charged an independent client 31 basis points for the same thing. J.A. 448. The percentage rate it thus charged its captive fund was more than twice what it charged the independent client. But in dollar terms, the difference was vastly larger, because the captive fund had much larger assets than the independent client ($7.7 billion versus $429 million). *Ibid.* In dollar terms, that means that the captive fund paid an advisory fee of $56.21 million (.73% times $7.7 billion), while the independent client paid only $1.33 million (.31% times $429 million) for essentially the same services. Thus, in dollar terms, respondent charged its captive fund 42 times what it charged an independent client. And these are advisory fees only; they do not include the additional fees that respondent charges its captive funds for administrative and other services.[11]

That evidence alone suggests that the concerns that led Congress to enact Section 36(b) are still present today. Certainly, the structural problems in the industry have remained: mutual fund boards remain completely dependent on their investment advisers, as the court of appeals itself conceded, and even greater fees have been reaped by advisers as mutual fund assets have ballooned

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[11] See *The Battle for the Soul of Capitalism* 199-200 (discussing three mutual fund advisers that charge three of their captive funds an average of seven times the *rate* that the same advisers charge a large pension fund with similar investment advisory needs (61 basis points versus 8 basis points), while the three advisers charge their captive funds in aggregate nearly 100 times the *dollars* charged to the pension fund ($56 million versus $600,000)).

to levels not dreamed of in 1970.[12] As in 1970, funds do not generally compete on the basis of costs, and investors accordingly are generally unaware of how much they are paying in costs or the enormous effects that such costs can have on performance over long periods of time. See, *e.g.*, GAO, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* 7 (2000) (http://www.gao.gov/archive/2000/gg00126.pdf); Alan Palmiter and Ahmet Tata, *Mutual Fund Investors: Divergent Profiles*, 2008 Colum. Bus. L. Rev. 934, 980-990, 1003-1008 (2008).

b. Coates and Hubbard did not directly study the level of fund fees, but instead studied the mutual fund market, and reasoned that lower fees give a competitive advantage to a fund in acquiring new assets. See *Coates/Hubbard* 174-184. Even if taken at face value, however, that proposition means only that there is a segment of the market in which customers seek low fund costs; the relative success of Vanguard demonstrates that fact. But the fact that *some* investors are sensitive to low costs, and that competition among funds for new investment money may place *some* limit on fund costs, does not mean that investment advisory fees overall are held to the competitive level that would be expected to result from in arm's-length transactions. The evidence adduced by Freeman and Brown and others is strongly to the contrary.[13]

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[12] At the time Congress was considering Section 36(b), total mutual fund assets were around $50 billion. 115 Cong. Rec. 13692 (1969) (Sen. Bennett). At the end of 2008, they were $9.6 trillion. 2009 *Investment Company Factbook* 9 (http://www.ici.org/pdf/2009_factbook.pdf).

[13] For example, although a recent study published by the American Enterprise Institute proposes as a remedy that Congress provide for a new industry structure, the study agrees with Freeman and Brown

Moreover, Coates and Hubbard are unable adequately to explain the observed facts—which they do not contest—that pension plans, other institutional investors, and Vanguard funds generally pay far less when they hire investment advisers than do captive mutual funds. Coates and Hubbard assert that comparisons of advisory fees paid by captive mutual funds with advisory fees paid by pension and other funds are not probative, because "[a] number of cost-related factors differ between public pension funds and retail customers, including liquidity requirements, number and size of accounts, and services provided to retail but not public pension plans." *Coates/Hubbard* 183-187. As Judge Posner said of the court of appeals' similar statements, Coates and Hubbard offer that explanation "purely as speculation, rather than anything having an empirical basis." Pet. App. 39a.

Indeed, no credible study has ever been able to isolate the assertedly large extra costs, somehow routinely hidden in fund advisory fees and disclosure prospectuses, that are said to make managing dollars in mutual fund portfolios so much more expensive than managing dollars in other institutional (*e.g.*, pension, college endowment, etc.) portfolios. And mutual funds, of course, typically pay separate and additional fees to the adviser for shareholder services, which are disclosed in prospectuses and other documents. In any event, the extremely low overall costs of many index funds offered by Vanguard and other firms, which essentially provide

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that the current industry structure produces advisory fees in excess of those that would prevail in a competitive market, despite competition among mutual funds for customers. See Peter J. Wallison & Robert E. Litan, *Competitive Equity: A Better Way to Organize Mutual Funds* 8-13, 61-69 (2007).

all mutual fund services to their shareholders *except* investment advice, establishes that the extra costs of serving retail customers could not possibly account for the much larger fees those customers pay. See generally *Freeman/Brown/Pomerantz, supra*, at 95-103, 113-117.[14]

5. Whether Coates and Hubbard, Freeman and Brown, or any other students of the industry are correct is ultimately, however, beside the point. Congress imposed a fiduciary duty on fund advisers, who violate that duty if they fail to make full disclosure *or* if they charge a fee that is higher than what would have been negotiated in a comparable arm's-length transaction. Nothing in the disputed empirical evidence about today's mutual fund marketplace could justify excusing advisers from satisfying the fiduciary duty imposed by Congress in Section 36(b).

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[14] The claim of Coates and Hubbard that prior studies, including the Wharton and SEC studies, did not adequately isolate advisory fees of mutual funds from their other management fees is mistaken. Petitioners in this case have in fact isolated advisory fees. See J.A. 352-353. More generally, there are a number of techniques—used by Freeman and Brown and others—to determine such fees. See *Freeman/Brown/Pomerantz*, 109-113, 117-121.

CONCLUSION

The judgement of the court of appeals should be reversed.

Respectfully submitted.

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JUNE 2009

APPENDIX

APPENDIX A

John Clifton Bogle

Employment Positions:

2000-present	Founder, Vanguard Group, and President of the Bogle Financial Markets Research Center
1996-2000	Senior Chairman, Vanguard
1974-1996	Chairman and Chief Executive Officer, Vanguard
Sept. 1974	Created The Vanguard Group
1970-1996	Chairman, Wellington Fund and associated funds
1967-Jan. 1974	President, Wellington Management Company
1965-1967	Executive Vice President, Wellington
1962-1965	Administrative Vice President, Wellington
1955-1962	Assistant to the President, Wellington
June 1951	Hired by Walter L. Morgan, Founder and Chairman, Wellington Management Co.

Directorships and Trusteeships:

1999-present	National Constitution Center, Chairman of the Board of Trustees, Chairman Emeritus
2000-2005	Instinet Corporation, Director
1996-2002	American Indian College Fund, Trustee
1996-2000	Chris-Craft Industries, Director
1989-1993	Princeton University Investment Company, Director
1981-1987	The American College, Trustee
1978-1999	Mead Corporation, Director & Chairman of Finance Committee

1975-2000	The General Accident Group of Insurance Companies, (later Connecticut Union), Director
1971-present	Blair Academy, Trustee, Chairman, 1986-2001
1971-1991	Meritor Financial Group, Director
1971-1991	Bryn Mawr Hospital, Director and Chairman, Finance Committee

Memberships and Committees:

2009	Financial Crisis Advisory Group
2007-present	Adirondack Roundtable Chairman
2006-present	Dow Jones Wilshire Advisory Board
2004-present	American Philosophical Society
2004-present	American Academy of Arts and Sciences
2003-present	*Journal of Investment Management*, Advisory Board
2003-present	Financial Analysts Journal, Advisory Council
2002-2003	Conference Board Commission on Public Trust and Private Enterprise
2002-2007	Phi Beta Kappa Society, Investment Committee
1997-2000	U.S. Independence Standards Board
1972-1976	National Assoc. of Securities Dealers, Chairman, Investment Companies Committee
1972 - 1978	Princeton University, Economics Dept. Advisory Council (Chairman 1978)
1969-1974	Investment Company Institute, Board of Governors (Chairman 1969-70)

Honorary Degrees:

May 18, 2007	Georgetown University, Doctor of Humane Letters
May 31, 2005	Princeton University, Doctor of Laws
May 15, 2005	Immaculata University, Doctor of Laws
May 15, 2004	Pennsylvania State University, Doctor of Humane Letters
June 14, 2003	Drexel University, Doctor of Business Administration
May 23, 2001	New School University, Doctor of Laws
May 13, 2001	Susquehanna University, Doctor of Laws
Dec. 15, 2000	Eastern University, Doctor of Humane Letters
June 11, 2000	University of Rochester, Doctor of Laws
Oct. 22, 1999	University of Delaware, Doctor of Laws
Oct. 15, 1999	Albright College, Doctor of Humanities
May 17, 1997	Widener University, Doctor of Humane Letters

Publications: Books

2008 *Enough. True Measures of Money, Business & Life* (Wiley, November 2008)

2007 *The Little Book of Common Sense Investing* (Wiley, March 2007)

2005 *The Battle for the Soul of Capitalism* (Yale University Press)

2002 *Character Counts: The Creation and Building of The Vanguard Group* (McGraw-Hill)

2000 *John Bogle on Investing: The First 50 Years* (McGraw-Hill)

1999 *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor* (Wiley)

1993 *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor* (Irwin)

1996 *John Bogle and the Vanguard Experiment: One Man's Quest to Transform the Mutual Fund Industry* (Written by Robert Slater, Irwin)

Publications: Articles

2008 *A New Order of Things: Bringing Mutuality to the "Mutual" Fund*, 43 Wake Forest L. Rev. 1089

2008 *Black Monday and Black Swans*, Financial Analysts Journal

2008 *A Question So Important That It Should Be Hard To Think About Anything Else*, The Journal of Portfolio Management

2007 *Reflections on "Toward Common Sense and Common Ground?,"* 33 J. Corp. L. 31

2005 *Bold Thinking on Investment Management: The FAJ 60th Anniversary Anthology*

2004 *Re-Mutualizing the Mutual Fund Industry—The Alpha and the Omega*, 45 B.C.L. Rev. 391

2004 *The Mutual Fund Industry Sixty Years Later: For Better or Worse?*, Financial Analysts Journal

2003 *Whether Markets are More Efficient or Less Efficient, Costs Matter*, CFA Magazine,

2003 *Don't Count On It! The Perils of Numeracy*, Journal of Investment Management,

2002 *An Index Fund Fundamentalist*, The Journal of Portfolio Management

2002 *Has Corporate Governance Let Us Down?* The Corporate Board

1998 *The Implications of Style Analysis for Mutual Fund Performance Evaluation*, The Journal of Portfolio Management,

1995 *The 1990s at the Halfway Mark*, The Journal of Portfolio Management,
1992 *Selecting Equity Mutual Funds*, The Journal of Portfolio Management
1991 *Investing in the 1990s: Remembrance of Things Past, and Things Yet to Come*, The Journal of Portfolio Management,
1997-present *The Wall Street Journal*, numerous op-eds
1999-2003 *The New York Times*, numerous op-eds

Awards:

2009 Outstanding Article Award for *A Question So Important That It Should Be Hard To Think About Anything Else*
2009 Graham & Dodd Perspective Article Award for "Back Monday & Black Swans"
2008 The Bonnell Award, Community College of Philadelphia
2007 Heritage Award, The Historical Society of Pennsylvania
2007 Union League Business Leadership Award
2006 Center for Corporate Excellence Exemplary Leader Award
2006 Chester County Economic Development Council Hall of Fame
2005 Friend of the Delaware Investor Award, Delaware Dept.of Justice
2004 Committee of Seventy, Philadelphia Good Citizenship Award
2004 Marketing Expo, Lifetime Achievement Award
2004 *Institutional Investor* Magazine Lifetime Achievement Award
2003 Cardiovascular Institute Leadership Award

2003 National Foundation for Teaching Entrepreneurship, Entrepreneur of the Year
2003 Yale School of Management, Legends of Leadership
2003 Better Business Bureau, Certificate of Commendation
2002 Union League of Philadelphia, Founders Award for Business Leadership
2002 Franklin Celebration in Philadelphia, Benjamin Franklin Founders Award
2000 Pennsylvania Chamber of Commerce, Pennsylvania's Business Leader of the Year
1999 Princeton University, Woodrow Wilson Award for "Distinguished Achievement in the Nation's Service"
1999 Fixed Income Analysts Society, Inc., Hall of Fame
1999 Partnership for Economic Education, Adam Smith Distinguished Leadership Award
1999 National Association of Personal Financial Advisers, Special Achievement Award
1999 National Investment Company Service Association, Robert L. Gould Award
1998 Assoc. for Investment Management and Research, Award for Professional Excellence
1997 Temple University, Musser Excellence in Leadership Award
1997 *Leadership in Financial Services* (Macmillan Press Ltd), one of the "Financial Leaders of the 20th Century"
1995 Advancement for Delaware Valley Independent Schools, Award for Philanthropy to Independent Education

1993 Financial Analysts of Philadelphia, Lifetime Award of Distinction
1992 Newcomen Society, Honor for innovation

Public Recognition:

2005	FINANCIAL PLANNING Magazine, Hall of Fame
2005	TIME magazine, "Ten Questions for John Bogle"
2004	TIME magazine, "The *Time* 100—the world's 100 most powerful and influential people"
2002-2004	Weekly program with Tyler Mathisen on CNBC
2001	Louis Rukeyser's Wall Street Week, Hall of Fame
1999	FORTUNE magazine, one of the investment industry's four "Giants of the 20th Century."
1999	*Barron's*, "Investment Hall of Fame"
1996	*Fund Action* Magazine, "Fund Leader of the Year"
Ongoing	Numerous appearances on: CNBC,C NN, Bloomberg, Fox Business, NPR

Other Achievements:

1999-2000	Henry Kaufmann Visiting Professor of Business, New York University
1999	Leadership Speakers Series, Fox School of Business Management, Temple University

Distinguished Lectures:

2009 Columbia Business School Stanley R. Klion Forum
2008 George Washington University, Manuel Cohen Lecture
2007 Princeton University, The Maclean House 2007 Lecture Series
2005 Vanderbilt University, Distinguished Speaker Series
2005 Duke University's Fuqua School of Business, Distinguished Speakers Series
2004 Washington State University, The Gary M.Brinson Distinguished Lecture
2003 Vanderbilt University, The Owen School of Management – Distinguished Speaker Series
2003 Wake Forest University, Joseph A. Jones Lecture
2003 Bryn Mawr Presbyterian Church, Community Forum Distinguished Speaker Series
2002 Cornell University, Park Distinguished Lecture Series
2002 Princeton University, Center for Economic Policy Studies
2002 Texas Christian University, M. J. Neeley School of Business, Executive Speaker Series
2002 Blair Academy, Hollerith Lecture Series
2000 New York University, Executive Lecture Series
2000 New York University, Seymour Jones Distinguished Lecture
1998 Massachusetts Institute of Technology (Lincoln Laboratories), Distinguished Lecture Series
1998 Houston Club, Distinguished Speaker Series

APPENDIX B

MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION IN RESPONSE TO QUERY BY CHAIRMAN MOSS REGARDING THE DIFFERENCES BETWEEN THE REASONABLENESS IN S. 34 AND THE "BREACH OF FIDUCIARY DUTY" STANDARD OF S. 2224 AND H.R. 11995 WITH RESPECT TO MANAGEMENT FEES

This memorandum is submitted in response to Chairman Moss' request on November 12, 1969, that we discuss the differences, if any, between the standard of "reasonableness" in respect of management fees in S. 34 and the "breach of fiduciary duty" standard of S. 2224 and H.R. 11995.

I.

The history of this change in language was related by Chairman Budge before this Committee on November 12, 1969:

"With respect to management fees, the Commission had recommended that the Investment Company Act should be changed to specify that management fees should be reasonable and to provide for court enforcement of this standard. S. 3724, passed by the Senate in July 1968, substantially adopted that recommendation with certain additional changes designed to meet some of the objections of the industry. S. 34, precursor to the present bill, contained the same provisions. However, the industry continued to oppose the form of the management fee amendments, although no one objected to the basic proposition that management fees should be reasonable and that the bill should change the present

standard of gross abuse of trust in Section 36 to some more realistic and stricter standard. Following the April 1969 Senate hearings, the commission and industry representatives resumed their discussions of this matter and in May 1969 agreed on and jointly submitted to the Senate Banking Committee, a provision in substitution of the reasonableness standard which would specify that the investment adviser has a fiduciary duty with respect to management fee compensation. This was in accord with the Commission's basic recommendation that the present effective standard 'waste' under state law, and gross abuse of trust under Section 36 of the Act as applied to management fees, be replaced with a more meaningful standard."

* * * * * * *

"Thus, H.R. 11995 and S. 2224 add a new Section 36(b) to the Investment Company Act to specify that the adviser has a fiduciary duty with respect to compensation for services or other payments paid by the fund or its shareholders to the adviser or to affiliated persons of the adviser. Other persons enumerated in Section 36(a) who may have a similar fiduciary duty with respect to compensation or payments received by them from the fund or its shareholders may also be sued for a breach of such duty in addition to liability imposed by Section 36(a). Subsection (b) also provides that payments by the fund to affiliated persons of the adviser are subject to challenge under this section. Approval of the management fee by the directors, and shareholder ratification is to be given such consideration as the court deems appropriate in the circumstances of a particular case.

The adoption of this standard precludes the assertion of a claim of ratification, although a vote of share-

holders or directors approving a management contract may be considered by the court in determining the fairness of the contract. The difficult waste test previously prevailing under state law in cases of ratification, and gross abuse of trust under present Section 36 of the Act, have thus been replaced by the more realistic standard, breach of fiduciary duty. The Commission views this as a significant and meaningful improvement over the existing law and at least as helpful as the reasonableness standard of S. 34, particularly in view of the restrictions on the enforcement of that standard which were contained in S. 34 but are not found in S. 2224 and H.R. 11995.

As the Senate Committee report pointed out, it is contemplated that the court would look at all the facts in connection with the determination and receipt of compensation by fund managers, including all services rendered to the fund or its shareholders and all compensation and payments received, in order to reach a decision as to whether the adviser has properly acted as a fiduciary in relation to such compensation."

As we have indicated, we cannot now state specifically at what levels a breach of fiduciary duty occurs in respect of management fee compensation since the circumstances will differ from fund to fund. In S. 34, the following factors were listed in Section 8 as among those to be considered in reaching a determination that a fee was unreasonable: The nature, quality and extent of the service to be rendered, the extent to which economies of scale and common management were shared with the fund, comparable charges made by the adviser to others and in the industry generally and the value of all other benefits received. S. 34 contemplated that in

the course of negotiating the management contract, fund directors would evaluate these and other relevant factors in order to determine whether the contract was fair to the fund. Although a specific list of factors as set out in Section 8(d)(2) of S. 34 is no longer included in the bill, it nevertheless seems clear that these and other similar factors would in any event be relevant to a determination of whether a fee is fair or constitutes a breach of fiduciary duty.

The change in language from unreasonableness to breach of fiduciary duty with respect to management fee compensation was made at the request of the industry, particularly the ICI after extensive negotiations between the ICI and the Commission. The reasonableness standard was not agreeable to the ICI, although they did not object to the proposition that management fees should be reasonable, because the ICI argued that the earlier standard would focus any court action which might arise on the conduct of the fund directors. The ICI wanted to shift the focus of any litigation in the fee area to the investment adviser. To accomplish this the reasonableness standard was replaced by the standard in H.R. 11995 which specifies that the investment adviser has a fiduciary duty with respect to management fee compensation. Because the Commission was satisfied that his change would not be detrimental to fund shareholders and that it would be possible with the change to still achieve the goal of fair and proper management fees, the Commission agreed to the change. It was felt that the substitution met the Commission's desire for a more meaningful and effective standard than the existing Section 36 language and the waste standard under state law. Under the new language, a breach of fiduciary duty occurs when a fiduciary per-

mits an unreasonable or excessive charge to be levied on the fund. The new language would not relieve the directors of a fund from their general fiduciary duty or insulate them from suit under Section 36(b), but it would achieve the ICI's purpose in focusing any fee litigation under that provision primarily on the adviser's role as a fiduciary and on the amount of the fee received rather than on the role of the fund's directors.

The short answer to the question posed by Chairman Moss then is that there is little substantive difference between the standard of reasonableness and the standard of breach of fiduciary duty. That this result was intended is made clear by Senator Bennett's statement on this issue on the floor of the Senate:

Last year's bill would have required that the fees should be reasonable, and no one disagreed. Under that bill, the question of whether a fee was or was not reasonable would have been determined by the Securities and Exchange Commission and the Federal courts. While the goal of reasonableness was accepted by all, the method of reaching that goal was offensive to many.

We have now deleted the entire management section from last year's bill and in its place added a subsection specifying that the investment adviser himself has a fiduciary duty with respect to the compensation he receives for services provided to the fund. As a fiduciary, the adviser and others who may receive compensation from the adviser's fee, are subject to lawsuits which may be instigated by shareholders or the Securities and Exchange Commission in the event that the fee received is claimed to be so excessive as to constitute a breach of fiduciary duty. Directors of the fund will, of course, continue to have a fiduciary responsibility with

respect to their own compensation and for the overall operation of the fund.

In determining whether the adviser has met his responsibility to the fund shareholders, the court must give appropriate weight to shareholder ratification of the management fee or its approval by directors.

This provision, instead of being an intrusion by the Federal Government, is in accordance with the traditional function of the courts to enforce fiduciary duties.

It is well established that both under the Investment Company Act and under general concepts of fiduciary law, the investment adviser is a fiduciary of the fund he advises. The industry has never seriously disputed this proposition. The court of appeals in *Securities and Exchange Commission* v. *Insurance Securities, Inc.*, 254 F. 2d 642, 650 (C.A. 9, 1958), *certiorari denied*, 358 U.S. 823, recognized that such a fiduciary relationship exists under the 1940 Act. Section 1(b)(2) states that one of the objectives of the Act was to eliminate situations in which "investment companies are organized, operated, managed or their portfolio securities are selected in the interest of directors, officers, *investment advisers* . . . or other affiliated persons thereof. . . ." (Emphasis added). The present Section 36 specifically imposes a duty on investment advisers not to engage in activities which would constitute gross abuse of trust in respect of the fund they manage. Sections 10 and 15, which permit affiliated persons of the investment adviser to serve on the boards of the funds they advise, also make clear that these affiliated directors are fiduciaries of the fund even though they may also be officers of directors of the investment adviser.

See *Brown* v. *Bullock*, 194 F. Supp. 207, 238-240 (S.D.N.Y., 1961), *affirmed*, 294 F. 2d 415 (C.A. 2, 1961).

Investment advisers like other corporate fiduciaries, such as banks, are entitled to make a profit, but they are not entitled to charge excessive or unreasonable fees. The law is especially alert to unfairness where affiliated persons of the fiduciary (the adviser) also serve on the board of the corporation (the fund). As the Supreme Court stated in its landmark opinion in *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590 at 599 (1921):

> The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation, and where the *fairness* of such transactions is challenged the burden is upon those who maintain them to show their *entire fairness* and where a sale is involved the full adequacy of the consideration. Especially is this true where a common director is dominating in influence or in character. (Emphasis added).[1]

The courts have long held that directors and other fiduciaries have a duty to deal with their corporations fairly and that a failure to accord such treatment to those they serve is a breach of fiduciary duty.[2] As the Supreme Court stated in *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939):

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[1] See also: *Globe Woolen Co.* v. *Utica Gas & Elec. Co.*, 212 NE 378 (N.Y. 1918) (Cardozo, J.).

[2] *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590 (1921); *Meinhard* v. *Salmon*, 249 NY 458, 164 NE 545 (1928); *Pepper* v. *Litton*, 308 U.S. 295, 311 (1939); *Shlensky* v. *South Parkway Building Corp.*, 90 Ill. 2d 268, 166 NE 2d 793 (1960).

"He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principals, equity will undo the wrong or intervene to prevent its consummation."[3]

Thus under the standard contained in the present bill, a breach of fiduciary duty involving management fees would occur when compensation to the adviser for his services is excessive in view of the services rendered—where the fund pays what is an unfair fee under the circumstances.[4]

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[3] That this statement is applicable in the 1940 Act context in cases involving violations of Sec. 36 was made clear in *Aldred Inv. Trust* v. *S.E.C.*, 151 F. 2d 254, 260 (CA 1, 1945), cert. denied, 326 US 795 (1946), one of the first cases decided under the Act.

[4] On the issue of the definition of fairness, the Supreme Court of Illinois in a case involving self-dealing directors stated:

While the concept of "fairness" is incapable of precise definition courts have stressed such factors as whether the corporation received in the transaction full value in all the commodities purchased; the corporation's need for the property; its ability to finance the purchase; whether the transaction was at the market price, or below, or constituted a better bargain than the corporation could have otherwise obtained in dealings with others; whether there was a detriment to the corporation as a result of the transaction; whether there was a possibility of corporate gain siphoned off by the directors directly or through corporations they controlled; and whether there was full disclosure --- *although neither disclosure nor shareholder assent can convert a dishonest transaction into a fair one. Shlensky* v. *South Parkway*

In summary, the failure of fiduciaries to deal fairly or reasonably with those to whom they are so obligated is a breach of fiduciary duty. It is also a breach of fiduciary duty to charge excessive or unreasonable fees. This was made explicit in the Commission's original explanation of S. 1659[5] and H.R. 9510.[6]

We would conclude on the basis of the foregoing that the effect of the shift in language from "reasonableness" to "breach of fiduciary duty" is primarily procedural and not substantive. It was designed to assure reasonable fees just as the original language of S. 34 was meant to do. The change would shift the focus of any litigation based on that Section from the directors of the fund to the investment adviser.

Bldg. Corp., 166 N.E. 2d 793, 801-02 (Illinois, 1960) (Emphasis added).

[5] Senate Hearings Committee on Banking and Currency, 90th Cong., 1st Sess., Pt. I, 139-141 (1967).

[6] House Hearings, Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce, 90th Cong., 1st Sess., Pt. I, 105-107 (1967).

APPENDIX C

Investment Company Institute
New York, N.Y., December 17, 1969

Hon. John E. Moss

Chairman, Subcommittee on Commerce and Finance, Committee on Interstate and Foreign Commerce, Rayburn House Office Building, Washington, D.C.

Dear Congressman Moss: In the course of my testimony on H.R. 11995, delivered on November 13, 1969 you requested the Institute's views on the legal meaning of the terms "reasonableness" and "fiduciary duty." This letter is in compliance with that request.

We have previously testified both before this Subcommittee and the Senate Committee on Banking and Currency as to why we were opposed to the provisions in S. 34 (91st Congress, First Session) introduced on January 15, 1969, making it a statutory requisite that advisory fees and other compensation be "reasonable" and authorizing litigation under this standard. In our view this might be interpreted to obligate a court to determine *de novo* on a case-by-case basis whether such compensation was in any particular case, in fact, "reasonable." We refer to our testimony at pages 241-243 of the printed House hearings on H.R. 9510 and H.R. 9511, 90th Congress, First Session, Serial No. 90-21 and at pages 298-299 of the printed Senate hearings on S. 1659, Part 1, 90th Congress, First Session and at page 100 of the printed hearings on S. 34, 91st Congress, First Session and ask that such testimony be considered as part of this response. Our basic concern was that in applying the "reasonable" standard the courts might

feel called upon to substitute their business judgment for that of the directors of the fund.

Section 20 of H.R. 11995 provides that the adviser has a fiduciary duty with respect to the receipt of his compensation paid by a registered investment company to the adviser. This provision differs from the "reasonableness" approach first in a procedural way. That is under the present provision a suit may be brought by the Commission or a security holder of the investment company only against the adviser or other person who received the compensation. The "reasonable" approach provided that recovery was limited to the recipients but did not eliminate non-recipients as parties to litigation.

As to the nature of the standard itself it is first of all clear that it is not intended to imply that the investment adviser is not entitled to make a profit or to suggest that any type of "cost plus" contract would be required. Thus, it should be recognized that the investment adviser is running a business which is a commercial enterprise, albeit subject to high standards of conduct.

We believe the court will look to the general law of fiduciary relationships which involve the negotiating of fees by a fiduciary with the other party to the particular transaction. In such situations it would appear that there is no question that a fiduciary can negotiate for his fee.

Many words have been used in attempting to describe how far a fiduciary may go in negotiating his fee without violating his fiduciary relationship. A good way to put it is that he may not overreach in the amount of his fee even though the other party to the transaction,

in full possession of all the facts, does not believe the fee is excessive. The court would undoubtedly consider whether the investment adviser has acted fairly and diligently in supplying information to the Board of Directors of the investment company so that they can function properly in establishing the terms of the advisory contract and in supervising the continuance of the arrangements with the adviser and its affiliated persons. In addition to considering the adviser's conduct the court would focus on the substance and quality of the negotiations which led to the contract in determining whether the adviser had breached his fiduciary obligations.

Sincerely yours,

Robert L. Augenblick

President and General Counsel

AMICUS CURIAE BRIEF

(22)

No. 08-586

In The

Supreme Court of the United States

JERRY N. JONES, et al.,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF AMICUS CURIAE OF CATO INSTITUTE IN SUPPORT OF RESPONDENT

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QUESTION PRESENTED

Section 36(b) of the Investment Company Act imposes on investment advisors a "fiduciary duty with respect to the receipt of compensation for services." Plaintiffs do not allege that investment advisor in this case misled the investment firm, or engaged in dishonest dealing in any respect. Is the advisor's compensation nevertheless a violation of its fiduciary duty simply because plaintiffs consider that compensation "excessive"?

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IDENTITY AND INTEREST OF AMICUS CURIAE

Pursuant to Supreme Court Rule 37.3(a), the Cato Institute respectfully submits this brief amicus curiae in support of the respondent.[1] Petitioners lodged consent to the filing of all amicus curiae briefs with the Clerk of this Court. Written consent for the filing of this brief was granted by counsel for respondent and lodged with the Clerk.

The Cato Institute was established in 1977 as a nonpartisan public policy research foundation dedicated to advancing the principles of individual liberty, free markets, and limited government. Cato's Center for Constitutional Studies was established in 1989 to help restore the principles of limited constitutional government that are the foundation of liberty. Toward those ends, Cato publishes books and studies, conducts conferences, publishes the annual *Cato Supreme Court Review*, and files amicus briefs with the courts. Cato Institute scholars have written a number of works discussing the importance of Constitutional protections for economic liberty against unreasonable government interference. *See, e.g.*, Kimberly C. Shankman and Roger Pilon, *Reviving the Privileges and Immunities Clause to Redress the Balance Among States, Individuals, and the Federal Government*, 3

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[1] No counsel for any party authored this brief in whole or in part. No person or entity, other than amicus curiae, its members or its counsel made any monetary contribution specifically for the preparation or submission of this brief.

Tex. Rev. L. & Pol. 1 (1998). Cato has also participated as amicus curiae before this Court in cases involving economic freedom and property rights, including *Powers v. Harris*, 544 U.S. 920 (2005), *Empress Casino v. Giannoulias*, 129 S.Ct. 2764 (2009), and *Stop the Beach Renourishment v. Florida Dep't of Envtl. Protection*, No. 08-1151 (2009). This case is of central concern to Cato because it addresses the scope of the freedom of contract and economic liberty that the Framers wrote into our Constitution – and threats to them that are felt most acutely during the current time of financial upheaval.

STATEMENT

This is a case about who gets to decide the compensation levels for investment professionals: regulators and judges, who base their decisions on their own conceptions of fairness, or consumers, whose decisions result from open and free bargaining in the competitive financial services marketplace. In a dynamic environment where thousands of mutual funds and mutual fund managers compete for individual, corporate, and institutional investors, should the government determine whether the fees charged by investment advisors are "reasonable"?

Harris Associates served as an investment advisor to three mutual funds. For these services, Harris received a fee according to a contract approved each year by the board of trustees that oversaw the three

mutual funds. *Jones v. Harris Associates, L.P.*, 2007 WL 627640 at *1 (N.D. Ill.). The board, comprising nine or ten members, delegated review of that contract to a committee that reviewed information about Harris's performance, the fees charged to Harris's other clients, and the fees charged by other advisors to their clients. *Id.* at **1-2. There is no allegation that Harris misled the board of trustees or any other person in negotiations over its compensation.

Three owners of shares in the above funds filed a derivative suit contending that Harris violated section 36(b) of the Investment Company Act in various ways; the relevant allegation here being that Harris's compensation was so disproportionate to the services rendered as to violate the "fiduciary duty with respect to the receipt of compensation for services." The court ruled for Harris, concluding that "the board as a whole was operating without any conflict that would prevent it from engaging in arm's-length negotiations with Harris," *id.* at *8, and that it was not evident that Harris received wildly disproportionate fees. On the contrary, the plaintiffs' evidence showed only that "others paid different amounts for similar [investment advisor] services." *Id.* at *9.

The Court of Appeals affirmed, observing that the fees charged by investment advisors are determined by private negotiations and kept in line by market competition. *Jones v. Harris Associates L.P.*, 527 F.3d 627, 631-32 (7th Cir. 2008). Disagreeing with the Second Circuit's decision in *Gartenberg v. Merrill*

Lynch Asset Mgt., Inc., 694 F.2d 923 (2d Cir. 1982), *cert. denied sub nom. Andre v. Merrill Lynch Ready Assets Trust*, 461 U.S. 906 (1983), the panel concluded that an advisor subject to section 36(b)'s fiduciary duty "must make full disclosure and play no tricks but is not subject to a cap on compensation. The trustees – and in the end investors, who vote with their feet and dollars – rather than a judge or jury, determine how much advisory services are worth." *Id.* at 632. The court denied rehearing en banc, over a dissent by five judges. *Jones v. Harris Associates, L.P.*, 537 F.3d 728 (7th Cir. 2008).

It is now up to this Court to determine whether the freely determined fees of investment advisers should be subject to review by the federal government.

SUMMARY OF ARGUMENT

All persons everywhere have a fundamental human right, recognized and protected by the Constitution, to earn a living and to keep the fruits of their labors. This means that as long as their dealings with others involve neither force nor fraud, each individual has the right to whatever compensation for his labor others agree to pay him. While the Investment Company Act rightly prevents fraud by imposing on investment advisors a fiduciary duty with respect to compensation, it imposes no limit on the amount of compensation an investment advisor may receive, so

long as the compensation agreement is freely and honestly adopted by both sides.

A "reasonableness" limit is not warranted by the plain text of section 36(b), which imposes only a "fiduciary duty"; that term has long been understood to require only honest dealing, not to require that "the terms of the contract . . . were 'fair,' whatever exactly that means." *Maksym v. Loesch*, 937 F.2d 1237, 1241 (7th Cir. 1991). Nor is it warranted by the structure of the market for investment advising services – a market which is dynamic, in which consumers have a wide array of choices, and in which competitive pressures restrain the amount of fees charged. To create a "reasonableness" limit would involve the federal judiciary in determining what sort of compensation is fair for investment advisors, and possibly other professionals subject to fiduciary duties. This would stretch the judiciary's role far beyond its constitutional boundaries and violate the right of honest individuals to choose what compensation they will receive from those with whom they make agreements. This Court should affirm the decision below and reject the Second Circuit's approach in *Gartenberg*, which unduly expanded the judicial role and now threatens the security of the fundamental right to earn an honest living.

ARGUMENT

I. ALL PERSONS HAVE A FUNDAMENTAL HUMAN RIGHT TO WHATEVER COMPENSATION THEIR CONTRACTING PARTNERS FREELY AND HONESTLY CHOOSE TO PAY THEM

Everyone everywhere has the right to pursue happiness through economic trade and production. Declaration of Independence, 1 Stat. 1, 1 (1776) ("all men . . . are endowed . . . with [the] . . . unalienable right[ ] [to] . . . the pursuit of happiness."); Thomas Jefferson, Letter to Joseph Milligan, April 6, 1816, *in* 14 *The Writings of Thomas Jefferson* 456, 466 (A.E. Bergh ed., 1907) ("the first principle of association" is " 'the guarantee to every one of a free exercise of his industry, and the fruits acquired by it.' "). As Charles Fried has observed, the law of contracts

> recognize[s] our rights as individuals in our persons, in our labor, and in some definite portion of the external world . . . [and] facilitates our disposing of these rights on terms that seem best to us. The regime of contract law, which respects the dispositions individuals make of their rights, carries to its natural conclusion the liberal premise that individuals have rights. And the will theory of contract, which sees contractual obligations as essentially self-imposed, is a fair implication of liberal individualism.

Contract As Promise 2 (1981).

The fundamental right to make contracts is guaranteed by the Constitution, which forbids the government from arbitrarily depriving persons of liberty, including the liberty to earn a living and keep the fruits of one's labor. *See, e.g., Lowe v. S.E.C.*, 472 U.S. 181, 228 (1985) ("'[i]t is undoubtedly the right of every citizen of the United States to follow any lawful calling, business, or profession he may choose.'" quoting *Dent v. West Virginia*, 129 U.S. 114, 121-22 (1889)); *Conn v. Gabbert*, 526 U.S. 286, 291 (1999) ("the liberty guaranteed by the Fourteenth Amendment denotes not merely freedom from bodily restraint but also the right of the individual to contract [and] to engage in any of the common occupations of life.") (citations omitted). As Justice William O. Douglas wrote, the right to earn a living is "the most precious liberty that man possesses. Man has indeed as much right to work as he has to live, to be free, to own property. . . . To work means to eat. It also means to live. . . . The great values of freedom are in the opportunities afforded man to press to new horizons, to pit his strength against the forces of nature, to match skills with his fellow man." *Barsky v. Board of Regents*, 347 U.S. 442, 472 (1954) (Douglas, J., dissenting).

The right to economic liberty – including the right to obtain and keep compensation for one's labors – is only part of the indefinite range of the liberty to which all are entitled. Because each person owns himself or herself, each person has such rights as the right to express his or her opinions, to travel without

unjustified obstruction, or to be free from assault or interference so long as he or she respects the equal right of others. So, too, each person has the right to employ his or her talents in the market and enjoy the fruits thereof. This realm of individual freedom was described by John Locke, who wrote that "every Man has a *Property* in his own *Person*. This no Body has any Right to but himself. The *Labour* of his Body and the *Work* of his Hands, we may say, are properly his." John Locke, *Second Treatise of Civil Government* sec. 27 at 328-29 (Peter Laslett rev. ed., 1963) (1690). Each person has the right to use his or her labor – whether physical labor or intellectual labor – to earn a living through exchange, for whatever compensation another person chooses to give.

Following Locke, the authors of the Virginia Declaration of Rights (George Mason and James Madison) explained, in a phrase later revised by Jefferson, that "all men are by nature equally free and independent, and have certain inherent rights . . . [including] the means of acquiring and possessing property, and pursuing and obtaining happiness and safety." Va. Decl. of Rights ¶ 1 (1776). The right to make money and acquire property with which to support oneself and one's family is a central aspect of individual liberty. Alexander Hamilton observed that "[t]rue liberty" includes "protecting the exertions of talents and industry and securing to them their justly acquired fruits." *In Defence of The Funding System* (1795) *reprinted in* 19 *The Papers of Alexander Hamilton* 1, 52 (Harold Syrett ed., 1973).

Likewise, James Madison explained that "the first object of government" is "the protection of different and unequal faculties of acquiring property." *Federalist* No. 10 at 78 (Clinton Rossiter ed., 1961).

Before emancipation, opponents of slavery emphasized that among its chief evils was that slavery violated this fundamental right to earn a living and to enjoy the fruits of one's labor. Senator Charles Sumner summed up the "ever-present motive power" of slavery as "simply *to compel the labor of fellow-men without wages!*" Cong. Globe 36th Cong. 1st Sess. 2592 (1860) (emphasis in original). Frederick Douglass likewise recalled the overwhelmingly liberating experience of earning his very first wages after escaping from slavery into freedom in Massachusetts. Douglass offered to help a neighborhood woman by moving some coal for her. "[T]he dear lady put into my hand *two silver half-dollars*. To understand the emotion which swelled my heart as I clasped this money, realizing that I had no master who could take it from me – *that it was mine – that my hands were my own*, and could earn more of the precious coin – one must have been in some sense himself a slave." *The Life and Times of Frederick Douglass* (1893) *reprinted in Douglass: Autobiographies* 654 (Library of America 1994) (emphasis in the original).

It was largely to guarantee the economic freedom of those who had once been slaves that the first Civil Rights Act was enacted in 1866 and the Fourteenth Amendment adopted. *See Jones v. Alfred H. Mayer Co.*, 392 U.S. 409, 432 (1968) (a leading reason for the

Civil Rights Act was to secure "the right to acquire property . . . the right . . . to make contracts, and to inherit and dispose of property."); Bernard Siegan, *Economic Liberties And The Constitution* 50 (1980) ("the [civil rights] act enumerates economic and not political concerns."); Timothy Sandefur, *The Right to Earn A Living*, 6 Chap. L. Rev. 207, 228-30 (2003) (the Fourteenth Amendment was intended to protect economic freedom of former slaves and others). In the years following the Civil War, federal courts generally acknowledged that the right to earn a living as one saw fit was a central component of the liberty guaranteed to all individuals. *See, e.g., Cummings v. Missouri*, 71 U.S. (4 Wall.) 277, 321-22 (1866); *In re Parrott*, 1 F. 481, 506 (C.C.D. Cal. 1880); *Truax v. Raich*, 239 U.S. 33, 41 (1915).

Obviously no person has a right to obtain money through force or fraud; to do so violates the rights of others. Government's proper role is to prevent force, fraud, and dangerous practices which might injure innocent persons. Justice Stephen Field, widely recognized as the leading defender of economic liberty in this Court's history, and the father of so-called "economic substantive due process," *see generally* Paul Kens, *Stephen J. Field: Shaping Liberty from The Gold Rush to The Gilded Age* (1999), nevertheless wrote the decision in *Dent*, 129 U.S. at 121-22, upholding an occupational licensing statute that required doctors to satisfy certain training requirements before practicing medicine. While reiterating that all persons have the right to earn a living

through free economic exchange, Field recognized that government could impose "conditions" on economic exchanges "for the protection of society." *Id.* But where no persons are injured or endangered by the economic activity at issue, the government has no legitimate role dictating the terms of those exchanges.

In *Morta v. Korea Ins. Corp.*, 840 F.2d 1452, 1460 (9th Cir. 1988), the Ninth Circuit explained in more modern terms the importance of the freedom to make economic trades: "Despite recent cynicism, sanctity of contract remains an important civilizing concept." *Id.* That right "embodies some very important ideas," including "that people have the right, within the scope of what is lawful, to fix their legal relationships by private agreement." *Id.* That right "'includes the freedom to make a bad bargain,'" the consequences of which the parties must shoulder. *Id.*

When an investment advisor, or any other person, agrees to perform a service for compensation, he has a right to that pay, no matter how large the amount may be, and regardless of whether others regard it as "excessive." Whenever anyone chooses to exchange his or her labor for compensation – whatever that labor might be, and whatever that compensation might be – that decision is an exercise of freedom of choice which deserves respect. So long as it is the result of free and fair bargaining practices, that agreement represents an exchange of values with which no outsider may interfere.

II. COURTS HAVE NO POWER TO SECOND-GUESS THE "REASONABLENESS" OF ANY SALARY OR COMPENSATION AGREEMENT HONESTLY AND FREELY SIGNED BY BOTH CONTRACTING PARTIES

A. Any Honest Exchange Is By Definition Fair

There is no such thing as a "reasonable" rate of pay in the abstract. All prices, including the price of labor, are set by mutual bargaining and exchange between the parties. The price of a good or service represents only the priorities that the parties to the exchange set on their alternatives. *See, e.g.*, George Reisman, *Capitalism: A Treatise on Economics* 206-209 (1996). This insight, known in economics as the "marginal revolution," banished forever the notion that there exists an abstract "value" to a good or services that prices must somehow "accurately" reflect. *See generally* Donald J. Boudreaux, et al., *Talk Is Cheap: The Existence Value Fallacy*, 29 Envtl. L. 765, 786-87 (1999). Salaries are set by the values placed on the product or service by consumers who compete to purchase the labor in question. There is no "correct" price or wage.

Where a person receives what appears to be a disproportionately large salary, this does not imply any wrongdoing by any party to the contract. It is the different and unequal talents of individuals who compete and interact in the economy, as well as the varying context of their needs and circumstances,

that account for the widely differing amounts of pay that employees receive.

Because the "reasonableness" of a particular rate of compensation cannot be compared to any universal standard, the reasonableness of compensation can be determined only by the parties to the contract itself. As Nobel laureate James Buchanan has said, "voluntary exchanges among persons, within a competitive constraints structure, generate efficient resource usage, *which is determined only as the exchanges are made.*" *Rights, Efficiency, And Exchange: The Irrelevance of Transaction Cost* (1984), *reprinted in* James M. Buchanan, *The Logical Foundations of Constitutional Liberty* 260, 273-74 (Indianapolis: Liberty Fund, 1999) (emphasis added). Consumers express their judgment as to that reasonableness by choosing whether to agree to the contract. In the absence of coercion or fraud, any economic exchange represents the judgment by the parties involved that the exchange is the best available determination of the parties' respective needs, costs, and priorities. No other standard exists by which to judge the "reasonableness" of contractual exchanges.

B. Federal Courts Lack The Knowledge Necessary to Judge What Compensation Is "Reasonable"

All economic exchanges take place between parties who have limited access to information. For a central authority or bureaucracy to oversee or plan

the "proper" form of economic exchanges would require the accumulation and management of a vast amount of information that, as Nobel laureate Friedrich Hayek observed, "never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge which all the separate individuals possess." *The Use of Knowledge in Society*, 35 Am. Econ. Rev. 519, 519 (1945).

The great informational benefit of free economic exchange is that it allows each individual to bring to bear on the problem of resource allocation his or her unique knowledge of "the particular circumstances of time and place." *Id.* at 522. This is done by price competition. It is impossible for any individual agent to harness the information needed to put the "correct" price on a product or service. Rather, given the opportunity to exercise her own judgment and freely employ her own resources, "each individual can act as if she knew the myriad alternative uses for the products she uses as well as each one of their component resources, and to employ those products only if her use is one of the most efficient possible." Christopher T. Wonnell, *Contract Law and the Austrian School of Economics*, 54 Fordham L. Rev. 507, 517 (1986). Bargaining and negotiation allows the resources to flow to those agents who value it most highly.

Rates of pay set by free competition reflect the myriad alternatives and priorities of the various actors in the market. If a firm overpays its executives,

investors will take their money elsewhere, requiring the firm to adjust its policies in the future; if the firm underpays, it will fail to attract talent, again creating an incentive for change in policy. The managers of the firms in question are in the best position to make judgments on such matters; no entity insulated from the incentives that the firms themselves face can hope to formulate a more accurate price for labor.

For example, imagine person X, who is offered a salary of $100,000 from one firm, $50,000 from another firm, and $250,000 from a third. These employment offers represent a mixture of information held by the three firms, each of which balances its own estimate of person X's effectiveness, training, or prestige, against the other candidates available to fill the position. The firms also weigh these estimates against their respective economic circumstances, their needs and future expectations, and what their investors are willing and able to pay. The first firm may be more interested in hiring person Y instead; the second firm may be considering moving to another locale, and bids low, while the managers of the third firm believe person X to be uniquely suited to manage their company, and are willing to offer a high salary. It is not possible for any central authority to gather the relevant information about each of these firms, compare them, and determine which one "ought" to employ person X, or what pay rate is "reasonable" for person X's services. As Prof. Richard A. Epstein recently observed, every business firm in the market "operates in its own distinctive environment in which compensation formulas have to

interact with the patterns of shareholder control, the type of direct regulation in place and the rapid movement in product markets." *Steering Clear of the Executive Compensation Bog*, Forbes Online, June 16, 2009.[2] Thus while the market salary for person X may not be an *a priori* "correct" price, it reflects the actual knowledge and needs of the participants in the market far better than could any price artificially set by a central authority. It is therefore a much more accurate valuation of X's services than any constructed "reasonable" price could be.

Federal courts are particularly ill-suited to guess at the "reasonable" valuation of products or services. Legislatures are in a poor enough position to assemble the information necessary for setting "proper" rates of pay, but they are at least subject to the competing pressures of citizens and groups who can express their views, negotiate toward a mutually acceptable resolution, and vote out of office those who make irresponsible choices. But federal courts are overseen by life-appointed judges who are not subject to incentives set by consumers; moreover, courts are limited by the rules of evidence to the information provided by the parties in a particular case. That information may be inaccurate, biased, or spun in a way that the parties hope will influence the court, regardless of the actual economic circumstances. The

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[2] Available at http://www.forbes.com/2009/06/15/salary-bonus-ceo-opinions-columnists-executive-compensation.html (visited August 24, 2009).

judiciary cannot apply the general standard of reasonableness to set the "correct" terms of an economic transaction.

In *Perkins v. Lukins Steel Co.*, 310 U.S. 113 (1940), this Court reviewed a suit in which the Secretary of Labor was statutorily authorized to set certain wages that the steel sellers must pay to workers if those sellers made contracts with the government. The Court found that courts could not intervene in the Secretary's wage determinations because "the process of arriving at a wage determination contains no semblance of these elements which go to make up a litigable controversy as our law knows the concept." *Id.* at 127. This is even more true of the process by which wages are determined in a free market, where private parties negotiate with each other on the basis of their knowledge to determine the rates of pay.

So, too, *Montana-Dakota Utilities Co. v. Northwestern Public*, 341 U.S. 246 (1951), held that courts could not intervene in an administrative determination as to what rate for utility services was "reasonable." Reasonableness, the Court observed, "is an abstract quality represented by an area . . . between what is unreasonable because too low and what is unreasonable because too high." *Id.* at 251. The judiciary could have no role in "reduc[ing] the abstract concept of reasonableness to concrete expression in dollars and cents." *Id.* Administrative determinations are based on a variety of facts and circumstances of which courts could know nothing;

judges could not impose "the disembodied 'reasonableness'" of their preferred price rates in the place of the agency with more facts at hand. *Id.* Courts have all the more reason to avoid imposing a disembodied concept of reasonableness on the compensation that mutual fund advisors receive as a consequence of honest and open negotiations to which sophisticated contracting parties bring their own knowledge and expertise.

In short, "[i]t is not within the power of a court to make a contract for the parties." *Taminco NV v. Gulf Power Co.*, 322 Fed. App'x. 732, 734 (11th Cir. 2009) (citation omitted). This is not simply a matter of judicial restraint; it reflects the fact that courts lack the knowledge and expertise necessary to determine the terms of a contract between the private parties, and any attempt to do so is likely to lead to confusion, perverted incentives, and an interference with individual rights.

C. The Argument That Mutual Funds Are Not Subject to Supply and Demand Is Misleading

Petitioners and their amici argue that the market for mutual fund advisory services is different from all other markets and, indeed, has suffered "market failure." *See, e.g.*, Brf. of AARP, sec. II. But as with most such claims, this argument overlooks some important basic principles. First, all markets are different from all other markets and have unique characteristics. The fact that one market does not

operate like another, or like an economist's hypothetical "perfect" model does not prove that it is non-competitive or that the forces of supply and demand do not work. Second, the presence of transaction costs and other factors that keep prices high does not prove that the market has "failed." Indeed, the market cannot be said to have "failed" simply because it fails to yield results that some people would prefer.

The AARP brief contends that mutual fund managers compete "on the basis of performance . . . rather than on the basis of the fees they charge." *Id.* at 15 (quoting U.S. Gov't Accountability Office, *Mutual Funds: Additional Disclosure Could Encourage Price Competition* 7 (2000)). But all economic competition consists of weighing costs and benefits. "Performance" in the market for investment advising services consists of obtaining for the client a high rate of return – one which will compensate the client for the fees charged to the client and return a profit to the client. John C. Coates IV and R. Glenn Hubbard, *Competition in The Mutual Fund Industry: Evidence And Implications for Policy*, 33 J. Corp. L. 151, 180 (2007) ("Mutual funds compete for investment funds by striving to outperform their rivals. Superior returns increase fund flows and market share.").

It is not meaningful, therefore, to say that advisors compete on the basis of performance rather than price – all product sellers or service providers compete for customers by offering a package of benefits, and it is the benefits of that package, when compared to its costs, that go by the name "performance." Nor can

the market be described as having "failed" simply because other investment options are less desirable, leading customers to remain with firms that pay advisors high rates. If a firm pays its advisors high rates but remains viable by comparison with other firms in free competition, this shows only that the firm is successful enough to afford high pay rates, not that the firm operates in a failed market.

The brief of amici curiae law professors, at 22, contends that "[i]f, as the evidence demonstrates, investors do not exit despite high fees – because of limited options in their 401(k) plans, adverse tax consequences, search costs, redemption fees, or other limitations – then advisors can make a great deal of money." But this hardly proves that the market has failed; it cannot be argued that a market is failing when investors are free to weigh different options and choose to invest their money in a manner that reduces possible tax consequences, search costs, and redemption fees. All consumers in all markets have limited options. To point to these limits as evidence of market failure is to define all markets as failures.

Moreover, to contend that consumers choose to remain with high cost firms when confronted with less desirable alternatives merely proves that they have chosen the option they believe offers them the highest rate of return.[3] Investors consider the cost of

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[3] Remarkably, the amici law professors, after acknowledging that investors presented with options regularly choose that

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exiting a fund when they first choose to invest their money: consumers are sensitive to the liquidity of their investments (or the lack thereof), and exit costs that limit liquidity factor into their assessment of a fund's performance. Exit fees are thus essentially part of the costs to entry into a particular investment. Consumers who choose to invest anyway have made a rational decision that the benefits outweigh those costs.

The market for investment advice is dynamic and competitive. *See* Coates and Hubbard, *supra* at 163 ("the mutual fund industry's market structure is consistent with competition providing strong constraints on advisory fees."). The number and variety of mutual funds is large and growing; barriers to entry for new firms are low; mutual fund fees have frequently decreased, and firms regularly gain and lose market share as is to be expected in a competitive market. *Id.*

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option that brings them the highest return with the lowest costs, claims that investors "have demonstrated little behavioral capacity to invest rationally"! *Id.* at 23. This is incoherent; if parties choose the best – or the least bad – option, they are by definition behaving rationally. The law professors base their assertion on the claim that "many investors fail to enroll in retirement plans, leave their contributions uninvested, or allocate their savings too rarely, riskily, or rapidly." *Id.* at 23-24. But many investors have good reasons for making these choices; many choose not to enroll in retirement plans or to invest their contributions because their circumstances are such that they prefer to keep money on hand for immediate needs. No individual or group can know these circumstances well enough to characterize all such choices as "irrational."

Contrary to the claims of petitioners and their amici, mutual funds do compete in terms of price, and this has direct effects on the fees charged by investment advisors. During the 1990s, funds that performed poorly regularly waived their fees to improve their overall competitiveness in the eyes of consumers, and even successful funds waived their fees for the same reason. *Id.* at 173. If, as the petitioners and their amici suggest, adviser fees were the product of collusion or perverse markets rather than price competition, advisor fees would steadily grow; yet "[t]he evidence is to the contrary; fee declines are relatively common. Widespread common fee reductions and waivers by advisers can only be explained by price competition in both money market and equity mutual funds." *Id.* at 174. And consumers do respond to costs: "investors shift substantial amounts of assets out of high-fee funds and into low-fee funds." *Id.* at 180.

What's more, competitiveness should not be assessed merely *within* the business model of mutual funds and their advisors; investors enjoy a variety of investment options other than mutual funds, and these alternatives create competitive pressure for mutual fund companies to lower costs or improve performance. Recent years have seen "the proliferation of new types of financial institutions, which is just what we would expect in a truly evolutionary system. . . . Not only have new forms of financial firm proliferated; so too have new forms of financial asset and service." Niall Ferguson, *The Ascent of Money* 354 (2009). Indeed, Ferguson likens the enormous

growth of different varieties of investment options to "the Cambrian explosion, with existing species flourishing and new species increasing in number." *Id.* at 355. Investors can choose to invest in any number of risky or safe strategies, with firms that pay top dollar to the best advisors they can find, or with firms that pay their investment advisors less.

In short, customers purchase a whole package of services when they invest their money – or when they purchase anything else. That package may contain certain anomalies, but if those anomalies do not make the value of the package as a whole unattractive to the customer, then the customer will still buy it, and will still be better off, even if others might consider the purchase unwise. For example, a restaurant that overpays the chef may still draw customers who believe the meals are good and the prices reasonable. Others may choose to patronize different restaurants. But it would be fallacious to describe the restaurant market as having "failed" because the chef is paid a disproportionate rate; the customers are satisfied with their choice among many options in a competitive market. This is true even if the market is characterized by "asymmetric information" – *i.e.*, if the customers do not know what the chef is paid. The market is working because customers have chosen (on the basis of "performance") the alternative that comes closest to their desires.

As Coates and Hubbard, *supra* at 167, explain,

> Firms have different business models and strategies. Some choose to compete for investors by offering extensive services, incurring higher costs with commensurately higher prices, while others choose to compete with less service, lower overhead, and lower prices. With hundreds of complexes seeking to gain a competitive advantage, "price" is an integral element of competition. The view that all fund complexes select not to compete on price, when price competition can gain new customers and increase adviser profits, is economically unfounded.

The evidence shows that "[b]oth advisers and fund directors are constrained by the effects of competition for fund investors." *Id.* at 212. Although the judges who dissented from rehearing here expressed doubt that high fees will drive investors away, *Jones*, 537 F.3d at 731, the fact is that high fees will drive investors away *if those fees render the firm as a whole less desirable to investors than the available alternatives.* If investors choose to remain, then the market cannot be said to have failed, even if particular aspects of the firm's operations seem anomalous to outsiders.

III. THE FIDUCIARY DUTY IN SECTION 36(b) REQUIRES ONLY FAIR DEALING, NOT ANY PARTICULAR OUTCOME

A. Fiduciary Duties Are Procedural, Not Substantive

The term "fiduciary duty" has long been understood to require fair dealing and honesty – not to require that a transaction have any particular outcome. It may be said by analogy to be a "procedural" rather than a "substantive" duty.

The fiduciary duty has been described as requiring good faith, candor, trustworthiness, or honesty. *See, e.g., Gresh v. Waste Services of America, Inc.*, 311 Fed. App'x. 766, 770-71 (6th Cir. 2009) ("fiduciary relationship turns 'on trust or confidence reposed by one person in the integrity and fidelity of another' that 'necessarily involves an undertaking in which a duty is created in one person to act primarily for another's benefit in matters connected with such undertaking' ") (citation omitted); *Employers Mut. Casualty Co. v. Collins & Aikman Floorcoverings, Inc.*, 422 F.3d 776, 779 (8th Cir. 2005) ("a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation") (citation omitted). It does not impose a substantive limitation on the fees that a fiduciary may charge her client, so long as those fees are freely and fairly negotiated.[4] Fiduciaries cannot

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[4] This is not to suggest that individuals would have any private right of action under section 36(b) to enforce the full

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take advantage of clients or deprive them of relevant decision-making information. But where an informed client agrees to pay a fiduciary a high fee, that fee does not violate the fiduciary duty.

Informed consent is the cornerstone of the fiduciary relationship. Fiduciaries and clients often enter into dangerous, complicated, or costly agreements; for example, doctors are fiduciaries to their patients, but often enter into agreements to provide expensive and risky medical treatments. So long as the doctor fully discloses the risks, the client's decision to enter into that agreement does not violate the fiduciary duty even if the doctor receives high pay and even if the patient suffers a foreseen injury. *See, e.g., Hendricks v. Central Reserve Life Ins. Co.*, 39 F.3d 507, 510 (4th Cir. 1994). Attorneys are also in a fiduciary relationship with their clients, one that requires them to disclose information to a client and explain its import but allows the client to make potentially unwise choices so long as he or she is fully informed. *See, e.g., Kroblin Refrigerated Xpress, Inc. v. Pitterich*, 805 F.2d 96, 106 (3d Cir. 1986).

Fiduciaries have no obligation to work for below-market rates or to limit what they may charge for their services. In *Maksym*, 937 F.2d 1237, an attorney sued a former client to recover fees. The client claimed the fees were unrecoverable because the attorney breached his fiduciary duty by charging an exorbitant rate. The Court of Appeals, speaking through Judge

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disclosure requirements of section 15(c); those requirements are enforced by the Securities and Exchange Commission.

Posner, rejected this argument on the grounds that attorneys, though fiduciaries, are nevertheless free to charge whatever compensation a client knowingly consents to pay. *Id.* at 1241. To contend that fiduciaries may never obtain a benefit for themselves in contracts with clients would be self-defeating: "As no one enters into a contract without hope of benefit, this argument if accepted would make all lawyers' contracts presumptively unenforceable." *Id.* As long as "the terms of the transaction were fully disclosed," and the transaction supported by consideration, the transaction is enforceable between the fiduciary and the client. *Id.*

In words equally applicable to this case, Judge Posner and his colleagues concluded that most fiduciary contracts are entered into for purposes of profit, rather than from charitable motives, "yet the contracts establishing them are held valid without the court's imposing on the . . . fiduciary the difficult burden of demonstrating that . . . the terms of the contract . . . were 'fair,' whatever exactly that means." *Id.* The *Makysm* decision was correct: Courts are in no position to impose a "fairness" limitation on fiduciaries' fees so long as fiduciaries act honestly and fairly in negotiating their terms of compensation.

B. The *Gartenberg* Approach Should Be Abandoned Because It Uses a Dubious Reading of Legislative History to Override Plain Statutory Language And Relies on Unconvincing Economic Propositions

The Second Circuit's decision in *Gartenberg*, 694 F.2d 923, should be overruled. That decision relies on

legislative history to supersede the statute's explicit language, and involves courts in second-guessing the honest contractual agreements formed by private parties.

The *Gartenberg* court relied on "excerpts from the [Investment Company] Act's tortuous legislative history," *id.* at 928, to conclude that section 36(b)'s fiduciary duty provision imposes a reasonableness limit on advisor fees. Admitting that this legislative history "contains statements . . . pointing in both directions," the court concluded that the term "fiduciary duty" was substituted for "reasonable" as "more a semantical than a substantive compromise." *Id.* Yet the court simultaneously decided that the use of the former term was "possibly intended to modify the standard somewhat." *Id.*

Such equivocal conclusions are precisely why courts are usually reluctant to rely on legislative history to override a statute's plain language. As this Court observed in *Lamie v. U.S. Trustee*, 540 U.S. 526 (2004), when asked to base its interpretation of a statute on the intentions of legislators, "competing interpretations of the legislative history make it difficult to say with assurance . . . [which party] lays better historical claim to the congressional intent. . . . These uncertainties illustrate the difficulty of relying on legislative history here and the advantage of our determination to rest our holding on the statutory text." *Id.* at 541-42. Congress may not have perfectly expressed its intent, but it alone is capable of comprehending that intent and putting it into statutory form, and "[i]f Congress enacted into law something

different from what it intended, then it should amend the statute to conform to its intent." *Id.* at 542. *See also Ardestani v. INS*, 502 U.S. 129, 137 (1991) ("ambiguities in the legislative history are insufficient to undercut the ordinary understanding of the statutory language"); *Patterson v. Shumate*, 504 U.S. 753, 761 (1992) ("Although courts appropriately may refer to a statute's legislative history to resolve statutory ambiguity, the clarity of the statutory language at issue in this case obviates the need for any such inquiry.") (citation omitted).

The *Gartenberg* decision also relied on dubious assertions about the status of economic competition for investment advising services. 694 F.2d at 929. According to that decision, competitive forces do not work for investment advisors as they do for other service providers because the cost to each investor is relatively small and because advisors' personal services are so crucial to the operation of an investment fund that a fund cannot easily change from one advisor to another. *Id.*

But as explained above, competition for investor dollars is robust; there are myriad financial instruments, investment mechanisms, and firms available to consumers. The fact that this specific method of investment involves paying high compensation rates to advisors with unique skills does not render the market for investment advice uncompetitive – any more than the gourmet restaurant business is rendered uncompetitive by the fact that particular chefs are highly paid for their special talents. As long as customers can choose the restaurant that provides the best quality food for a cost they are willing to pay,

competition will restrain the chef's pay to an amount that is profitable in light of consumer preferences.

Similarly, it may be true that "competition between money market funds for shareholder business" is "governed by different forces" than is competition "between advisor-managers for fund business," *id.*, but this is irrelevant: all markets are distinct and subject to unique forces. As long as consumers are free to choose between different packages of investment services and pick that package which gives them the best return for the lowest cost, that market is competitive, and concerns for the "reasonableness" of an advisor's salary are misplaced. *Cf. United States v. Syufy Enterprises*, 903 F.2d 659, 668 (9th Cir. 1990) ("[W]hen a producer . . . suppl[ies] a better product at a lower price, when he eschews monopoly profits, when he operates his business so as to meet consumer demand and increase consumer satisfaction, the goals of competition are served.").

Gartenberg held that courts could "evaluat[e] a fee's fairness" in part by comparing it to "the price charged by other similar advisers to [other] funds." 694 F.2d at 929. But there are many reasons why funds might charge different prices from investors: institutional investors might enjoy volume discounts, for example. Funds that engage in riskier investment strategies might seek more educated or experienced advisors, whom they must pay more, and therefore charge more to clients, while more conservative funds charge less. To compare the fees charged by various different funds, each of which has significantly different characteristics, is deeply misleading.

Nor should it matter that the advisor's compensation costs each investor a small amount. *Cf. id.* at 929. The same is true of most compensation for services in the market: a chef's salary is a small amount of each customer's dinner tab. Yet that does not mean, as the *Gartenberg* court claimed, that what a firm pays its employees is "competitively insignificant." *Id. No* cost is "competitively insignificant": All costs add up to a total that consumers compare to the benefits that they receive. Thus if an investor considers "$2.88 *a year* for each $1,000 invested," *id.* (emphasis in original), to be an insignificant cost compared to the benefit received, then that choice is a reasonable economic decision; it does not prove that the market for investment advisor services is uncompetitive and in need of court oversight.

In short, *Gartenberg* relied on an unconvincing interpretation of ambiguous legislative history to override the plain language of section 36(b) and transform a fiduciary duty – long understood as a procedural limitation requiring honest dealing and full disclosure – into a substantive "reasonableness" limitation. *Gartenberg* also relied on a flawed economic understanding that ignored the competitive characteristics of the market for investment advice. Contrary to that decision, "[c]ompetition among funds is strong, and competition constrains advisers in proposing fees, so that the general breakdown in arm's-length bargaining that has been assumed by the 1960s view is unconvincing." Coates and Hubbard, *supra* at 214. *Gartenberg* should be overruled.

CONCLUSION

Interpreting the fiduciary duty imposed by section 36(b) to impose a "reasonableness" limit on the amount of fees charged by an investment advisor would threaten the fundamental right of investment advisors to earn whatever compensation they freely negotiate with their clients; would force federal courts to make economic determinations for which they are unsuited; and would exceed all prior understanding of the meaning of the fiduciary duty. It would thus threaten the right of all professionals who exercise fiduciary duties to seek and obtain compensation for their services. This Court should follow the lower-court trend and hold that the fiduciary duty applicable to investment advisors requires only fair and honest negotiations. The decision of the Seventh Circuit Court of Appeals should be *affirmed*.

DATED: September, 2009.

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AMICUS CURIAE BRIEF

(20)

No. 08-586

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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INTEREST OF *AMICUS CURIAE*[1]

The Chamber of Commerce of the United States of America (the "Chamber") is the world's largest business federation. The Chamber represents an underlying membership of more than three million companies and professional organizations of every size, in every industry sector, and from every region of the country. The Chamber represents the interests of its members in matters before Congress, the Executive Branch, and the courts. The Chamber regularly files *amicus* briefs in cases that, like this one, raise issues of vital concern to the nation's business community.

Members of the Chamber and their subsidiaries include investment advisers, some of whom unfortunately and unfairly have been sued as defendants under § 36(b) of the Investment Company Act of 1940 (the "ICA" or the "Act"), 15 U.S.C. § 80a (2006) for allegedly charging "excessive" fees for the work they do in managing mutual funds. Members of the Chamber also include investors in mutual funds governed by the Act. The Chamber thus is familiar

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief are on file or have been submitted to the clerk.

Pursuant to Rule 37.6, *amicus curiae* affirms that no counsel for a party authored this brief in whole or in part, and no such counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *amicus curiae,* its members or its counsel made a monetary contribution to its preparation or submission.

with the everyday norms and practices of the mutual fund industry, both from the perspective of investment advisers that are entitled to charge management fees for the services they provide, and from the perspective of investors, who understand that paying such management fees is part of the cost of investing in mutual funds.

The Chamber has a particular interest in this litigation because of its potential adverse effect on all participants in the mutual fund industry. Section 36(b) was enacted for one purpose: to enable mutual fund investors to recover the repayment of excessive management fees. It is not a vehicle for private plaintiffs to police the process by which investment advisory fees are set or to challenge a fund's disclosures regarding those fees. Other statutory provisions address process and disclosure issues; but these other provisions do not create the expansive private cause of action that petitioners would read into § 36(b). Section 36(b) should not be construed in a manner that would enable private plaintiffs to do precisely what Congress denied in other provisions.

Some have suggested that the Court use this case to send a message regarding executive compensation in corporate America. This Court's task is interpreting statutes, not "sending messages." If the federal government is going to get involved in regulating executive compensation, particularly for companies that are *not* receiving government assistance, that kind of radical departure (which the Chamber would vigorously oppose) must come from the elected legislative branch, not the judiciary. *See*

Eldred v. Ashcroft, 537 U.S. 186, 222 (2003) ("The wisdom of Congress' action, however, is not within our province to second-guess.").

SUMMARY OF ARGUMENT

This case is one of hundreds filed in recent years alleging that mutual fund advisers violated their fiduciary duties under § 36(b) of the Investment Company Act by supposedly charging "excessive fees" for their services and otherwise committing various wrongs. Petitioners are shareholders of three funds in the Oakmark "family" of mutual funds managed by respondent. Respondent earned fees for its services pursuant to a written agreement, the terms of which were vetted and approved by the funds' independent trustees and described in detail in the funds' public filings. Petitioners thus purchased their shares in arm's-length transactions after respondent's fee rates were fully disclosed.

Because there are thousands of funds in the highly competitive mutual fund market, petitioners were free to invest their money in other funds if they felt respondent's fees were too high. And after freely investing in the funds, petitioners were in no way prevented from redeeming their shares and investing their money elsewhere if they believed respondent's performance was sub-par. But like others who have jumped on the litigation bandwagon, petitioners instead seek to use § 36(b) to boost their returns after the fact, challenging the process by which respondent's fees were set and the disclosures the funds made regarding that process. In making that

claim, however, petitioners would have the Court construe § 36(b) in a way that is contrary to the clear language of the statute and the purpose Congress intended it to serve, and would lead to all manner of abuse.

First, the broad and amorphous scope of § 36(b) liability suggested by petitioners is inconsistent with the text and structure of the Investment Company Act and other provisions of the federal securities laws. The plain language of the statute, directed explicitly at an adviser's "receipt of compensation for services," precludes actions under § 36(b) for other and different wrongs. That is confirmed by § 36(b)'s legislative history. As that history shows, Congress envisioned that the process of setting fee rates was best left to the "business judgment" of mutual fund directors, who were to set fees with an eye toward "best industry practice," and without interference by shareholder litigations. Instead, any claim that the process by which management fees were set was improper is exclusively enforceable by the SEC under separate provisions of the Investment Company Act and the Investment Advisers Act of 1940 (the "Advisers Act"), not by private litigation under § 36(b). To be sure, private investors may bring claims against certain defendants alleging false and misleading disclosures in fund documents under the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"), but only to the extent investors actually purchased or sold securities based on those disclosures. To permit mere pre-existing holders of

mutual fund shares to sue for misleading disclosures under § 36(b), as petitioners' position implies, would allow them to circumvent the limits on private shareholder litigation in the 1933 and 1934 Acts. Nothing in the Investment Company Act or any of the other federal securities laws supports such a result.

Second, petitioners' approach to § 36(b) would lead to precisely the sorts of mischief Congress purposefully sought to avoid.

i. Congress was wary that § 36(b) could be abused by plaintiffs' lawyers, and reversed the burden of proof normally applicable in fiduciary cases to prevent that from happening. Unfortunately, Congress' concern that § 36(b) would generate strike suits by unscrupulous lawyers has proved all too well-founded. The practical reality is that, despite the overwhelming popularity of mutual funds among consumers, the level of "excessive fee" litigation has exploded in recent years. Using § 36(b) as a catch-all tool to remedy any type of alleged misdeeds or omissions, plaintiffs' lawyers have brought suits against advisers regardless of the level of disclosure of fee information, the level of management fees themselves, or the net return to fund investors at the end of the day. Indeed, even advisers who charge below-average fees, generate above-average returns, or both, have been named as § 36(b) defendants. The present case is no exception. Congress did not intend § 36(b) to be a boon for the plaintiffs' bar.

ii. Under petitioners' proposed standard, it would be unduly difficult for defendants to secure

dismissal of unmeritorious claims at the early stages of litigation. This is directly at odds with the plain language of § 36(b), which puts the burden squarely on plaintiffs to demonstrate that the adviser breached its fiduciary duty through the receipt of excessive fees, and would effectively force defendants to undergo costly discovery in all cases, no matter how weak.

iii. Petitioners' approach would create coercive pressure to settle even meritless suits and burden funds and their shareholders with unnecessary costs. This Court has repeatedly recognized the enormous burdens that discovery in securities cases entails and the settlement leverage such burdens unfairly generate.

iv. The highly expansive interpretation of § 36(b) advocated by petitioners would cause detrimental ripple effects throughout the industry, burdening advisers, funds and fund shareholders alike. Advisers that risk suit despite earning below average fees may simply opt against offering mutual funds, hampering competition and leaving investors with fewer mutual fund options. Moreover, the costs of defending such suits are not borne by advisers alone. Despite the fact that they are not party defendants, the funds are also subject to costly discovery in such suits, and may be contractually obligated to pay for the costs of the adviser's defense. Because mutual funds are nothing more than the pooled investments of their shareholders, the real losers are therefore investors, out of whose pockets the costs of abusive fee litigation ultimately come.

ARGUMENT

I. PETITIONERS' APPROACH IS CONTRARY TO THE TEXT AND STRUCTURE OF THE INVESTMENT COMPANY ACT AND OTHER PROVISIONS OF THE FEDERAL SECURITIES LAWS.

A. By Its Plain Terms, § 36(b) Does Not Provide A Private Right Of Action For Alleged Flaws In The Process By Which Management Fees Are Set.

Petitioners interpret the fiduciary duty in § 36(b) of the Investment Company Act to extend to the adviser's disclosure of information to the mutual fund's directors. (Pet. Br. at 17.) Under their proposed approach, an adviser would breach its fiduciary duty if the process by which the fee is set were flawed in some way, regardless of whether the fee actually agreed upon was "excessive" in any respect. This interpretation of § 36(b) is flatly belied by express terms of the statute and its legislative history.

Section 36(b) creates a "narrowly circumscribed right of action for damages." *Transamerica Mortgage Advisors, Inc. (TAMA) v. Lewis*, 444 U.S. 11, 22 n.13 (1979). Under its terms, § 36(b) creates a fiduciary duty only "with respect to the *receipt* of compensation for services, or of

payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser." 15 U.S.C. § 80a-35(b) (emphasis added). Likewise, no action may be brought under § 36(b) against anyone other than the "*recipient* of such compensation or payments." 15 U.S.C. § 80a-35(b)(3) (emphasis added). And any damages awarded against such a *recipient* as a result of such breach "shall in no event exceed the amount of compensation or payments *received*." *Id.* (emphasis added). Because both the duty created by § 36(b) and the relief it provides for any breach are expressly limited to the "receipt" of excessive compensation, there is simply no textual basis to read § 36(b) as creating a private cause of action for any other or different wrongs. *See, e.g., Migdal v. Rowe Price-Fleming Int'l., Inc.*, 248 F.3d 321, 328-329 (4th Cir. 2001) (§ 36(b) limited to the receipt of excessive fees; it does not provide a right of action for breaches of fiduciary duty governed by § 36(a)).

Moreover, the plain terms of § 36(b) are confirmed by its legislative history. As that history shows, Congress did not intend to create a private right of action under § 36(b) to correct alleged flaws in the compensation-setting process unless those procedural flaws caused the receipt of excessive payments. *See* H.R. Rep. No. 91-1382, at 37 (1970) (even fee deliberations that were "a mere formality . . . would not be controlling in determining whether or not the fee encompassed a breach of fiduciary

duty"); S. Rep. No. 91-184, at 15 (1969) (same). On the contrary, Congress envisioned that the process of setting fees was best left to the "business judgment" of mutual fund directors, who were to approve rates with an eye to "best industry practice" without interference by shareholder litigation.[2] *See* S. Rep. No. 91-184, at 6 (§ 36(b) "is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors"); *id.* ("the best industry practice will provide a guide"); 15 U.S.C. § 80a-15 (process for approval of management contracts); *see also In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 122 (Del. Ch. 2009) (the business judgment rule is designed to "prevent[] judicial second guessing" of director decisions) (internal quotations omitted). Congress meant § 36(b) to provide a private claim only if a certain outcome occurred -- the receipt of excessive fees -- not to police the process.

B. The Private Right Of Action Under § 36(b) Should Not Include Claims Based On Conduct Governed By § 15(c) Of The Act.

Congress was, of course, concerned with the process by which management fees are set, but opted to address that issue in § 15 of the Act -- not § 36(b) -- which governs the duties of fund directors in that

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[2] The Oakmark funds at issue here had trustees, rather than directors, but the terms are synonymous under the Act. *See* 15 U.S.C. § 80a-2(a)(12).

process. As this Court has previously acknowledged, "Congress' purpose in structuring the Act as it did is clear." *Burks v. Lasker*, 441 U.S. 471, 484 (1979). "It was designed to place the unaffiliated directors in the role of independent watchdogs," and give them "the *primary responsibility* for looking after the interests of the funds' shareholders." *Id.* at 484-85 (emphasis added; internal quotations omitted).

Under § 15 of the Act, no person shall serve as an investment adviser to a mutual fund except pursuant to a written contract that has been approved by a majority of the non-interested -- *i.e.*, independent -- members of the fund's board. *See* 15 U.S.C. §§ 80a-15(a), 80a-15(c), 80a-2(a)(19). Before they approve or renew an advisory contract, the directors are required under § 15(c) to request such "information as may reasonably be necessary to evaluate" its terms, and the adviser is under a "duty . . . to furnish [this] information[.]" *Id.* The SEC requires disclosure of the information the board considered in approving or renewing an advisory contract, including:

> [1] the nature, extent, and quality of the services to be provided by the investment adviser; [2] the investment performance of the fund and the investment adviser; [3] the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates . . . [4] the extent to which economies of scale would be realized as the fund grows; and [5] whether fee levels reflect these

> economies of scale for the benefit of fund investors.

17 C.F.R. § 240.14a-101 (2009). No fee contract may be approved by the directors unless it "[p]recisely describes all compensation to be paid thereunder." 15 U.S.C. § 80a-15(a)(1).

The power to enforce compliance with § 15(c) resides exclusively with the SEC. *See* 15 U.S.C. § 80a-41 (providing for SEC enforcement of the Act). Nevertheless, according to petitioners' approach, the very conduct governed by § 15(c) could also form the basis of a private right of action for breach of fiduciary duty under § 36(b), the only private right of action expressly recognized under the Act. (*See* Pet. Br. at 11-12.) Under well-established rules of statutory interpretation, however, § 36(b) is clearly inapplicable to conduct regulated by the SEC under § 15(c).

Statutory construction is a "holistic endeavor." *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988). The "settled rule" is that the Court "must, if possible construe a statute to give every word some operative effect." *Cooper Indus., Inc. v. Aviall Servs., Inc.*, 543 U.S. 157, 167 (2004). Different parts of a statute must be read in conjunction with one another, so that none is interpreted in a way that renders another superfluous. *Corley v. United States*, 129 S. Ct. 1558, 1566 (2009) (a "statute should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant")

(internal quotations omitted). When legislation expressly provides a remedy or remedies, "courts should not expand the coverage of the statute to subsume other remedies." *Nat'l R.R. Passenger Corp. v. Nat'l Ass'n of R.R. Passengers*, 414 U.S. 453, 458 (1974). "This principle of statutory construction reflects an ancient maxim – expressio unius est exclusio alterius." *Id.*

Thus, when a statute provides for a private right of action for some but not all of its provisions, the scope of that private right will be construed narrowly. *See id.* at 457-458 (statute explicitly authorizing private suits in limited types of cases did not create a right to sue for causes of action arising under the act as a whole); *Alexander v. Sandoval*, 532 U.S. 275, 290 (2001) ("The express provision of one method of enforcing a substantive rule suggests that Congress intended to preclude others."); *Olmsted v. Pruco Life Ins. Co. of N.J.*, 283 F.3d 429, 433, 433 n.3 (2d Cir. 2002) (contrasting ICA § 36(b) with §§ 26(f) and 27(i) and stating that "Congress's explicit provision of a private right of action to enforce one section of a statute suggests that omission of an explicit private right to enforce other sections was intentional"). Indeed, a private right of action under a securities statute should not be construed to overlap with areas of enforcement specifically delegated exclusively to the SEC. *See, e.g.*, *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 771 (2008) (expanding the scope of the private right of action under § 10(b) of the Securities Exchange Act of 1934 to include claims specifically

made enforceable only by the SEC would "undermine Congress' determination that this class of defendants should be pursued by the SEC and not by private litigants").

Under these settled principles, therefore, the private right of action under § 36(b) of the Act does not include claims based on conduct governed by § 15(c). *See Green v. Nuveen Advisory Corp.*, 295 F.3d 738, 744 (7th Cir. 2002) (refusing to expand § 36(b) claim to include claims under other sections of the ICA or state law).

To hold otherwise would have the same effect as creating an implied private right of action under § 15(c), something this Court has emphatically "caution[ed] against." *See Stoneridge*, 128 S. Ct. at 772 ("[I]t is settled that there is an implied cause of action *only* if the underlying statute can be interpreted to disclose the intent to create one.") (emphasis added). Accordingly, no court that has considered the issue has held that a private right of action exists under § 15(c). *See, e.g., Gartenberg v. Merrill Lynch Asset Mgmt, Inc.*, 528 F. Supp. 1038, 1067 (S.D.N.Y. 1981) ("Sections 15(b), 15(c), and 20(a) of the Act were not intended to and do not establish a private right of action in the context of a claim such as here for recovery of compensation under Section 36(b). The structure of the Act makes clear that no private remedies other than Section 36(b) seeking restitution of advisory fees shall be implied, brought or maintained and no other relief shall be granted against the recipient of the payments made."), *aff'd*, 694 F.2d 923 (2d Cir. 1982); *Halligan v.*

Standard & Poor's/Intercapital, Inc., 434 F. Supp. 1082, 1084 (E.D.N.Y. 1977) ("Since § 36(b) affords a complete remedy for excessive fees paid to investment advisers, there is no need to imply a right of action under § 15(c). The duty created by § 15(c) can be enforced by the Securities and Exchange Commission"). Thus, alleged violations of § 15(c) should not be a permissible basis for a private party's claim under § 36(b).

C. The Private Right Of Action Under § 36(b) Should Likewise Not Include Claims Based On Conduct Governed By § 206 Of The Investment Advisers Act.

Petitioners' expansion of § 36(b) liability to reach alleged process violations would also improperly encroach upon § 206 of the Investment Advisers Act and the rules promulgated thereunder. Section 206(2) is a broad anti-fraud provision, which prohibits an investment adviser from engaging "in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client" and imposes on investment advisers a fiduciary duty to their clients to act in "utmost good faith," fully and fairly disclose all material facts, and use reasonable care to avoid misleading clients. *See* 15 U.S.C. § 80b-6(2); *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963). Proof of scienter is not required to establish a violation of § 206(2). *Steadman v. SEC*, 603 F.2d 1126, 1134 (5th Cir. 1979), *aff'd* 450 U.S. 91

(1981); *see also* 17 C.F.R. § 275.206(4)-8(a)(1) (2009) (investment adviser may not make any "untrue statement of a material fact or [] omit to state a material fact necessary to make the statements made . . . not misleading, to any investor or prospective investor in the pooled investment vehicle").

Like that in § 15(c) of the Investment Company Act, the authority to enforce § 206 of the Investment Advisers Act and Rule 206(4)-8 rests exclusively with the SEC. *See* 15 U.S.C. § 80b-9; Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, Investment Advisers Act of 1940 Release No. 2628, 72 Fed. Reg. 44,756, 44,760 (final rule adopted Aug. 9, 2007) (Rule 206(4)-8 "does not create a private right of action"). The SEC has exercised that authority, bringing actions against investment advisers who allegedly failed to provide sufficient information to mutual fund directors regarding management fees. *See, e.g., SEC v. Am. Birthright Trust Mgmt. Co.*, Litigation Release No. 9266, 21 SEC Docket 1241 (Dec. 30. 1980); *New York Life Inv. Mgmt. LLC*, Cease-and-Desist Order, Investment Advisers Act of 1940 Release No. 2883, Investment Company Act of 1940 Release No. 28,747 (May 27, 2009); *see also* U.S. Gen. Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition*, at 93 (June 2000)[3] (citing instances uncovered by SEC examinations of deficiencies in directors' review of fees).

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[3] *Available at* http://www.gao.gov/archive/2000/gg00126.pdf

Section 36(b) should not be construed to include claims based on conduct governed by § 206 of the Investment Advisers Act. The two statutes comprise companion legislation whose provisions must be read together as part of a single regulatory scheme. *See Transamerica Mortgage*, 444 U.S. at 22 n.13 (construing the Investment Advisers Act in conjunction with the 1970 amendments to the Investment Company Act.) To allow a private right of action under § 36(b) for claims covered by § 206 would permit plaintiffs to effect an end-run around this Court's ruling in *Transamerica Mortgage* that no private right of action under § 206 exists. *Id.* at 24 ("we hold that there exists a limited private remedy under [§ 215 of] the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable").

D. Petitioners' Approach Would Effectively Override The Limits Of The Federal Securities Laws, Which Provide Relief Only To Investors Who Purchased Or Sold Securities Based On Inaccurate Disclosures.

Petitioners complain that there were certain misstatements and omissions in the funds' SEC disclosures, suggesting that these should be actionable under § 36(b). (*See* Pet. Br. at 11-12.) As its plain terms make abundantly clear, however, § 36(b) is not a disclosure provision. Instead, § 34(b)

of the Act specifically prohibits misleading or omissive disclosure. *See* 15 U.S.C. § 80a-33(b) (prohibiting misleading statements in fund registration statements and other disclosure documents). Section § 34(b) is enforceable exclusively by the SEC. *See* 15 U.S.C. § 80a-41 (providing for SEC enforcement of the Act); *Bellikoff v. Eaton Vance Corp.*, 481 F.3d 110, 117 (2d Cir. 2007) ("the text and the structure of the ICA reveal no ambiguity about Congress's intention to preclude private rights of action to enforce §§ 34(b), 36(a), and 48(a)"). To the extent that rights of action to remedy disclosure violations are available to private litigants, those rights are set out in other provisions of the federal securities laws (equally applicable to mutual funds), which were carefully crafted by Congress to provide claims for new purchasers or sellers of securities, not for investors like petitioners who are pre-existing holders.

Section 11(a) of the 1933 Act gives a private right of action against various potential defendants with respect to a "registration statement . . . contain[ing] an untrue statement of material fact or omitt[ing] to state material fact required to be stated therein" only to a "person acquiring such security." 15 U.S.C. § 77k(a). Similarly, § 12(a)(2) creates an express right of action for "a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading" only for "the person purchasing such security." 15 U.S.C. § 77l(a)(2). In

addition, § 10(b) of the 1934 Act prohibits fraudulent statements or omissions "in connection with the purchase or sale[] of any security." 15 U.S.C. § 78j(b).

As this Court has recognized, Congress determined to limit these protections to those who "actually purchased or actually sold" securities pursuant to allegedly false disclosures -- not to pre-existing holders. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 736 (1975) (private rights of action under "the 1933 and 1934 Acts are by their terms expressly limited to purchasers or sellers of securities"); *Holmes v. Sec. Investor Prot. Corp.*, 503 U.S. 258, 277 (1992) ("[I]n *Blue Chip Stamps* . . . we confirmed the federal courts' 'longstanding acceptance' of the rule that a plaintiff must have actually purchased or sold the securities at issue in order to bring a Rule 10b-5 private damages action.") (O'Connor, J., concurring). Indeed, *Blue Chip Stamps* explicitly rejected extending claims under the 1933 and 1934 Acts to "actual shareholders in the issuer who allege that they decided not to sell their shares because of any unduly rosy representation or a failure to disclose unfavorable material" in a prospectus. 421 U.S. at 737-38. "When Congress wished to provide a remedy to those who neither purchase nor sell securities," the Court observed, "it had little trouble doing so *expressly*." *Id.* at 734 (emphasis added).

Accordingly, if a disclosure regarding mutual fund fees contains a material misstatement or omission, an investor who purchases or sells mutual fund shares in reliance on that misstatement has a remedy under the 1933 Act and/or the 1934 Act

against certain defendants, provided he or she also alleges and proves the other necessary elements of those claims.[4] However, no remedy is available under those provisions to a mutual fund investor who did not engage in a purchase or sale transaction based on alleged misrepresentations but simply continued to hold. To permit pre-existing holders of mutual fund shares to sue for misleading disclosures under § 36(b), as petitioners suggest, would allow them to evade the rule that only purchasers and sellers are entitled to bring disclosure claims. Nothing in the Investment Company Act or any of the other federal securities laws supports such a result.

II. PETITIONERS' APPROACH IS IMPRACTICAL AND UNDERMINES CONGRESS' INTENT AS TO THE PROPER SCOPE AND PURPOSE OF § 36(b).

A. The Practical Reality Is That Excessive Fee Litigation Is Lawyer-Driven.

At the time it enacted § 36(b), Congress was wary that the private cause of action it was creating could be used as a tool to harass and might lead to the filing of strike suits. *See* H.R. Rep. No. 91-1382, at 8

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[4] For limits on which potential defendants may be sued under § 10(b) of the 1934 Act, *see Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 177-178 (1994); *Stoneridge*, 128 S. Ct. at 773-774.

(§ 36(b) not meant to allow "the harassment of investment advisers by ill-founded and nuisance law suits, the so-called strike suit"). To mitigate against that risk, Congress reversed the burden of proof normally applicable in fiduciary cases, and placed the onus on plaintiffs to prove that a breach had occurred. *See* 15 U.S.C. § 80a-35(b)(1) (the "plaintiff shall have the burden of proving a breach of fiduciary duty"); *Green v. Fund Asset Mgmt., L.P.*, 286 F.3d 682, 685 (3d Cir. 2002) ("At common law it was incumbent on the fiduciary to justify his transaction with his cestui. Under this statute . . . the burden is reversed") (quoting *Gartenberg v. Merrill Lynch Asset Mgmt, Inc.*, 528 F. Supp. 1038, 1044 n.6 (S.D.N.Y.), *aff'd* 694 F.2d 923 (2d Cir. 1982)). Unfortunately, Congress' concern that § 36(b) would generate "strike suits by unscrupulous lawyers more interested in fees than the shareholders," 116 Cong. Rec. 33,279, 33,283 (1970) (Remarks of Rep. Stuckey), has proven all too well-founded.

Since § 36(b) was enacted in 1970, competition in the mutual fund industry has increased tremendously, fees have trended downward, and investors have benefited from an expanded array of mutual fund options. In the early 1960s, before the Act was amended to add the present § 36(b), fewer than 200 funds existed, with $23 billion under management. Wharton Sch. Of Fin. & Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 87-2274, at 4 (1962). By 1966, that number had increased to only 379 funds, managing a total of just over $38 billion in assets. *See* John C. Coates IV and R. Glenn Hubbard,

Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151, 157 (2007) (hereinafter "Coates & Hubbard"). In the nearly 40 years since § 36(b) was enacted, the mutual fund market has become much larger and more competitive. By 2008, the number of mutual funds in the United States had proliferated to nearly 9,000, with almost $10 trillion under management. *See* Investment Company Institute ("ICI"), *2009 Investment Company Factbook*, at 9, 15 (2009).[5] As competition has expanded, fees and expenses have gone down. Between 1980 and 2008, the asset-weighted average of total fees and expenses (which includes management fees, as well as sales loads, advertising and promotional charges, and other fees and expenses) fell among bond and stock funds by more than 57 and 63 percent, respectively. ICI, *Trends in the Fees and Expenses of Mutual Funds, 2008*, at 2 (2009).[6] *See also* Eleanor Laise, *As Returns Sag, Fund Investors Focus on Fees*, The Wall Street Journal, June 25, 2008, at D1 (mutual fund expense ratios fell "substantially" between 2003 and 2006).

At the same time, increased transparency regarding mutual fund management fees has become the norm. All mutual funds are required to disclose the amount of fees charged, the method by which fees are calculated, and the information fund directors considered in arriving at the fee. *See* SEC Form N-1A, Item 3 (requiring disclosure of the percentage of

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5 *Available at* http://www.ici.org/pdf/ 2009_factbook.pdf.

6 *Available at* http://www.ici.org/pdf/fm-v18n3.pdf.

management fees that are deducted from fund assets); Item 14 (requiring disclosure of the "method of calculating the advisory fee payable by the Fund"); 17 C.F.R. § 240.14a-101 (requiring disclosure of information upon which the board relied in determining the adviser's fee, including any comparison to the fees, services, and performance of other fund advisers, and the fees and services the adviser provides to other clients); SEC, Division of Investment Management, *Report on Mutual Fund Fees and Expenses* (Dec. 2000)[7] ("All funds are required to disclose their fees and expenses in a uniform manner so that an investor contemplating a fund investment today has access to comparable information about competing funds. This information helps investors make better investment decisions."). Indeed, the SEC recently issued new rules requiring that information regarding management fees be more prominently located in disclosure documents. Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Release No. 33-8998, 74 Fed. Reg. 4546, 4552-53 (Jan. 26, 2009). As the SEC explained, it adopted these new rules because it believes that "placement of the fee table in a more prominent location will encourage investors to give greater attention to costs." *Id.* at 4553.

Despite all of that, there has been an explosion in the number of cases brought against mutual fund

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[7] *Available at* http://www.sec.gov/news/studies/feestudy.htm

advisers. In the past several years, over 500 private class actions and derivative suits against mutual fund investment advisers have been commenced, with more suits being filed each day. James N. Benedict, Mary K. Dulka and Kimberly Wolf Price, *A Perfect Storm: Analyzing the Recent Explosion of Mutual Fund Litigation*, 1 Sec. Litig. Rep. 20, 20 (2004). Many of those lawsuits asserted claims under § 36(b) and were aimed at the advisers of the country's major mutual fund complexes. James N. Benedict et al., *Recent Developments In Litigation Involving Mutual Funds And Investment Advisers*, 2009 Prac. Law. Inst. Order No. 18,789, 1732 PLI/Corp. 943, 950.

The tsunami of excessive fee claims has been fueled by plaintiffs' lawyers, who have charged that the mutual fund "industry" at large is guilty of bilking innocent investors by charging exorbitant fees. For example, the website for co-lead plaintiffs' counsel in this case states:

> "Unfortunately, however, the over 53 million American households that have chosen to entrust their hard-earned dollars to mutual fund advisors and distributors are being taken advantage of in the form of excessive and unlawful fees and other abuses, which ultimately deplete the return on investment they seek . . . . For decades, the mutual fund industry has violated its duties to investors and the mutual funds they own by charging exorbitant fees . . . Richardson, Patrick, Westbrook & Brickman has sought to hold the

> mutual fund industry accountable for reaping excessive fees and profits at the expense of fund investors."[8]

Unsurprisingly, therefore, § 36(b) claims are not typically limited to particular individual funds. Instead, excessive fee litigation usually involves claims against advisers of entire fund complexes (*i.e.*, a family of different funds established by the same sponsor and managed by the same adviser), regardless of the size of the individual funds within the complex, their different investment styles, their performance, or their fee structure. Accordingly, excessive fee cases have even been filed on behalf of plaintiffs who do not own any shares in many of the funds that are the subject of their claims. *See, e.g., In re Salomon Smith Barney Mut. Fund Fees Litig.*, 441 F. Supp. 2d 579, 607 (S.D.N.Y. 2006) (suit brought against 88 funds in same complex despite fact that plaintiffs did not hold shares in 68 of those funds); *Forsythe v. Sun Life Fin., Inc.*, 417 F. Supp. 2d 100, 117 (D. Mass. 2006) (suit brought against family of 62 funds, although plaintiffs owned shares in only two of them); *In re Scudder Mut. Funds Fee Litig.*, No. 04-1921, 2007 WL 2325862, at *10 (S.D.N.Y. Aug. 14, 2007) (suit brought against more than 50 funds in same family; plaintiffs owned shares in three).

The targeting of mutual fund complexes has resulted in excessive fee cases being brought against advisers who charge fees that are actually *lower* than

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[8] *Available at* http://www.rpwb.com/mutual_funds/.

the median fees charged by competitors across the mutual fund industry. The evidence shows that funds with higher than average fees are typically smaller funds. Ajay Khorana and Henri Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry*, at 3, 20 (2004).[9] Conversely, the median fees charged by the largest adviser firms are substantially lower than the overall median across all mutual fund categories. Denise A. Martin et al., NERA Econ. Consulting, *Trends on Mutual Fund Advisory Fees*, at 18 (2006).[10] Yet, the advisers of some of the nation's largest mutual fund families are often sued as § 36(b) defendants. In fact, based on the reported cases, advisers to more than half of the 50 largest mutual fund families in the United States (ranked by assets under management as of the third quarter of 2008)[11] have been sued under § 36(b).[12]

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[9] *Available at* http://papers.ssrn.comsd3/papers.cfm?abstract_id=240596.

[10] *Available at* http://www.nera.com/publication.asp?p_ID=2872.

[11] The list of fund families ranked by assets under management as of the third quarter of 2008 is available at http://genxfinance.com/2008/12/23/list-of-50-largest-mutual-fund-companies-ranked-by-assets-for-2008/.

[12] *See, e.g., Migdal*, 248 F.3d at 325 (T. Rowe Price Funds); *Verkouteren v. Blackrock Fin. Mgmt., Inc.*, No. 99-9005, 2000 WL 298255, at *1 (2d Cir. Mar. 21, 2000) (BlackRock Funds); *Alexander v. Allianz Dresdner Asset Mgmt. of Am. Holding, Inc.*, 509 F. Supp. 2d 190, 193 (D. Conn. 2007) (PIMCO funds); *In re Franklin Mut. Funds Fee Litig.*, 478 F. Supp. 2d 677, 679-80 (D.N.J. 2007) (Franklin Templeton Funds); *In re Oppenheimer*

The litigation strategy pursued by the plaintiffs' bar has also resulted in excessive fee claims being brought against advisers of funds that outperformed the market while charging average or below-average fees. The present case is a prime example. The fees charged by Harris Associates were "in line" with those charged by "similar funds managed by other companies," as the trial court found. *Jones v. Harris Assocs. L.P.*, No. 04-8305, 2007 WL 627640, at *8 (N.D. Ill. Feb. 27, 2007). At the same time, Harris Associates delivered real "value" to investors for that money. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 631 (7th Cir. 2008). All three of the funds at issue in this litigation significantly outperformed their peers. For example, during the three-year period ended March 31, 2004, the Oakmark Global Fund was ranked first in net returns out of 254 comparable funds as defined by Lipper. (J.A. at 138, 147.) The Oakmark Equity and Income Fund had the highest average annual net return of its 445 peers for the five-year period ending March 31, 2004. (J.A. at 146.) And, the Oakmark Fund ranked in the top four percent of funds in terms

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Funds Fees Litig., 426 F. Supp. 2d 157, 158 (S.D.N.Y. 2006) (Oppenheimer Funds); *In re Dreyfus Mut. Funds Fee Litig.*, 428 F. Supp. 2d 357, 357 (W.D. Pa. 2006) (Dreyfus Funds); *In re Morgan Stanley & Van Kampen Mut. Fund Sec. Litig.*, No. 03-8208, 2006 WL 1008138, at *5 (S.D.N.Y. Apr. 18, 2006) (Van Kampen and Morgan Stanley Funds); *In re Am. Mut. Funds Fee Litig.*, No. 04-5593, 2005 WL 3989803, at *4 (C.D. Cal. Dec. 16, 2005) (American Funds); *In re Davis Selected Mut. Funds Litig.*, No. 04-4186, 2005 WL 2509732, at *2 (S.D.N.Y. Oct. 11, 2005) (Davis Funds).

of net returns for the three-year period ending March 31, 2004. (J.A. at 147.). As a result of this performance, the Oakmark Fund and the Oakmark Equity and Income Fund made *Barron's* and *Money* magazine's lists of the world's top 100 mutual funds in August 2003. (J.A. 148.) The Oakmark Global Fund and the Oakmark Equity and Income Fund were also included in Lipper's 2004 list of 35 funds that "provided consistently superior returns in their respective groups." (*Id.*) In addition, the individual managers of the Oakmark Global Fund and the Oakmark Equity and Income Fund were named as the top managers in their respective investment categories by *Barron's* in 2004. (J.A. 149.)

There can be little doubt, therefore, that § 36(b) is currently being used by plaintiffs' lawyers in a way Congress never envisioned and purposefully sought to avoid. Indeed, this litigation is one of multiple lawsuits commenced by the same plaintiffs' counsel against dozens of funds in separate complexes, with complaints that were virtual carbon copies of one another.[13] Petitioners' boundless approach to § 36(b) will surely exacerbate this problem, not prevent it.

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[13] *See, e.g., Hunt v. Invesco Funds Group*, No. 04-cv-2555 (S.D. Tex); *Baker v. Am. Century Inv. Mgmt.*, No. 04-cv-4039 (W.D. Mo.); *Gallus v. Am. Express Fin. Corp.*, No. 04-cv-4498 (D. Minn.); *Strigliabotti v. Franklin Res., Inc.*, No. 04-cv-883 (N.D. Cal.); *Dumond v. Mass. Fin. Servs. Co.*, No. 04-cv-11458 (D. Mass.); *Krueger v. Neuberger Berman Mgmt., Inc.*, No. 05-cv-1316 (S.D.N.Y.); *Williams v. Waddell & Reed Inv. Mgmt. Co.*, No 04-cv-2561 (D. Kan.).

B. That An Adviser Does Not Disclose That It Charges Different Fees To Different Clients For Different Services Provides No Basis To Infer A Violation Of § 36(b).

Petitioners posit that the fiduciary duty in § 36(b) requires "full and accurate disclosure of all material facts" in connection with the determination of management fees, regardless of whether the omission of such facts would have had any impact on the fees actually awarded. (Pet. Br. at 21.) In particular, they suggest that the rates an adviser charges to "different clients" are "highly probative" of whether a breach of fiduciary duty has occurred (*id.* at 30-31) and that therefore such rates (and the reasons for the differences) must always be disclosed (*id.* at 37). If petitioners were correct, however, it would be virtually impossible for defendants to secure dismissal of even the weakest of claims without having to go through the costly and burdensome discovery that the defense of securities claims notoriously entails.

For example, petitioners appear to recognize that the fact that an investment adviser charges different rates to different clients does not necessarily amount to a violation of § 36(b). (*See id.* at 30-31, 37.) And indeed, there are many significant differences between the services investment advisers provide to registered mutual funds and those they provide to different clients that justify different fee arrangements. *See* ICI, *Mutual Funds and*

Institutional Accounts: A Comparison, at 1 (2006)[14] (comparisons between fees charged to mutual funds and fees charged to institutional funds "can be highly misleading because of the dissimilarities between mutual funds and institutional accounts") (hereinafter "Comparison Study"); Coates & Hubbard, at 185 ("retail and institutional customers consume different services or differ in the underlying cost of generating services").

For example, while the services provided to institutional clients are principally limited to security selection, mutual funds are heavily regulated (by the ICA and other securities laws) and require significant compliance services that are not typically applicable to institutional clients. Comparison Study at 5-6; Coates & Hubbard at 162, 185. In addition, mutual fund shares are typically held by a large number of relatively small accounts, which makes recordkeeping, transfer agent, and related services more costly. Comparison Study at 3-5; Coates & Hubbard at 185, 192 n.158. Investment advisers also commonly provide mutual fund clients with shareholder-related services that institutional investors do not require. Comparison Study at 3-5; Coates & Hubbard at 162, 185. Advisers who manage mutual funds also face business and entrepreneurial risks that are absent when they provide services to institutional clients.

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[14] *Available at* http://www.anbid.com.br/institucional/documentos_download/Fundos/Estudos%20e%20Estat%C3%ADsticas%20Mundiais/ICI%20-%20Mutual%20Funds%20and%20Institutional%20Accounts.pdf

The start-up of a new mutual fund requires an investment of financial and human capital, and carries the risk that this investment will not be recouped. Comparison Study at 8.

Thus, the mere fact that an adviser charges different fees to different clients provides no basis to infer that an adviser received excessive compensation from a mutual fund.

Congress recognized that a fund's board of directors is in the best position to determine what information it needs and what fees are proper. 15 U.S.C. § 80a-15(c) (directors to request "such information as may reasonably be necessary" to determine fees); S. Rep. No. 91-184 at 6 (§ 36(b) "is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees"); 15 U.S.C. § 80a-35(b)(2) (courts to give appropriate consideration to board's approval of management fees). The practical effect of petitioner's approach, however, is that a § 36(b) plaintiff would be able to evade dismissal merely by alleging the commonplace fact that different fees were charged to different clients. Such an allegation would thus be the key that always opens the door to massive discovery concerning whether those fee differences were warranted or not.

A § 36(b) plaintiff should not be entitled to subject defendants to massive discovery and burden our already overworked courts merely by making rudimentary and conclusory allegations of breach,

without ever having to allege facts demonstrating causation, injury, or the other elements of a claim. *See* 15 U.S.C. § 80a-35(b)(3) ("[a]ny award of damages against such recipient [of excessive advisory fees] shall be limited to the actual damages resulting from the breach of fiduciary duty"); *see also Dura Pharms., Inc. v. Boudro*, 544 U.S. 336, 346 (2005) ("plaintiffs' need to *prove* proximate causation and economic loss leads us also to conclude that the plaintiffs' complaint here failed adequately to *allege* these requirements") (emphasis in original); *Ashcroft v. Iqbal*, 129 S. Ct. 1937, 1949-50 (2009) (no discovery should be permitted in the absence of factual allegations sufficient to demonstrate a plausible right to relief); *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544, 570 (2007) (same).

C. Petitioners' Approach Would Create Coercive Pressure To Settle Even Meritless Suits.

As Congress recognized in considering reforms to the 1934 Act, discovery accounts for 80 percent of the costs of defending securities law claims. H.R. Rep. No. 104-369, at 37 (1995) (Conf. Rep.). Discovery also requires "key employees" to dedicate substantial time to depositions and responding to discovery requests. *Id.* Just as in the § 10(b) context, the burdens of discovery in § 36(b) cases fall disproportionately on defendants because they "possess[] the bulk of the relevant information." H.R. Rep. No. 104-50, at 16 (1995). Plaintiffs, by contrast, have few documents that could be subject to

burdensome discovery requests and therefore have no incentive to propound reasonable discovery demands.

The enormous costs of discovery create tremendous pressure on defendants to settle, as both Congress and this Court have recognized. *See, e.g.*, H.R. Rep. No. 104-369, at 31 (plaintiffs can often use discovery to "impose costs so burdensome that it is often economical for the victimized party to settle"); H.R. Rep. No. 105-803, at 13 (1998) (Conf. Rep.) (companies often settle strike suits "simply to avoid the potentially bankrupting expense of litigating"); *Stoneridge*, 128 S. Ct. at 772 (noting that "extensive discovery and the potential for uncertainty and disruption in a lawsuit allow plaintiffs with weak claims to extort settlements from innocent companies"); *Dura*, 544 U.S. at 347 (refusing to "permit a plaintiff with a largely groundless claim to simply take up the time of a number of other people, with the right to do so representing an *in terrorem* increment of the settlement value rather than a reasonably founded hope that the discovery process will reveal relevant evidence") (internal quotation marks omitted); *see also Amron v. Morgan Stanley Inv. Advisors Inc.*, 464 F.3d 338, 346 (2d Cir. 2006) (quoting *Dura* in affirming dismissal of § 36(b) complaint).

Petitioners' broad standard for what constitutes a breach of fiduciary duty thus would arm § 36(b) plaintiffs with the ability to extract settlements regardless of the underlying merits of their claims. That is not a result Congress intended in enacting § 36(b), nor one this Court should allow.

D. Petitioners' Approach Would Unfairly Burden Advisers, Funds And Fund Shareholders Alike.

Petitioners' broad-based approach to § 36(b) would also cause detrimental "ripple effects," *Cent. Bank*, 511 U.S. at 189, throughout the industry, unfairly burdening advisers, funds and shareholders alike.

First, if advisers are faced with the prospect of having to defend excessive fee suits even when their fees are not excessive compared to industry averages, they may simply opt out of offering mutual funds altogether, diminishing the number of mutual funds available for investment and dampening competition. *See* John C. Coates IV, *Reforming the Taxation and Regulation of Mutual Funds: A Comparative Legal and Economic Analysis*, at 30 (2009)[15] (noting that other types of collective investment vehicles that are not subject to the ICA have been growing faster than funds subject to the ICA, and predicting that within ten to 20 years there will be more assets in the former category than in the latter); Herbert Lash, *Over 250 Mutual Funds Liquidate, Cite Rule Costs*, Reuters, Sept. 14, 2005 (over 250 mutual funds liquidated in 2008, primarily due to costs of complying with new regulations). That will redound to the detriment of all mutual fund investors, who will be left with fewer investment choices.

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15 *Available at* http://www.capmktsreg.org/research.

Second, although § 36(b) claims are directed against advisers, they also pose an economic cost to the funds themselves, on whose behalf such claims are ostensibly brought. For example, discovery in a § 36(b) case will often include the depositions of a fund's directors or trustees and the production of a significant volume of documents by the fund. *See, e.g., Williams v. Waddell & Reed Mgmt. Co.*, No. 04-2561 (D. Kan. Sept. 25, 2006) (Stipulation of Dismissal) (noting that plaintiffs have "sought and obtained substantial discovery from W&R and certain non-parties," including deposing "more than twenty senior representatives of W&R and eight independent directors on the Funds' Boards of Directors"). The costs and burdens associated with this discovery are borne by the fund, not the adviser, and do not constitute recoverable damages even if the case succeeds.

Third, it is in fact the shareholders who usually end up footing the bill for the costs of defending abusive § 36(b) claims. Under the ICA, a management agreement may provide for advancement rights, requiring funds to cover an adviser's legal costs upon an undertaking to repay and provided certain other conditions are met. 15 U.S.C. § 80a-17(i); Indemnification by Investment Companies, Investment Company Act of 1940 Release No. 11,330, 45 Fed. Reg. 62,423 (Sept. 4, 1980) (Sept. 4, 1980) (funds may advance attorneys' fees to adviser under certain conditions). Many management contracts contain such advancement provisions. *See, e.g.*, Brazilian Equity Fund, Inc., Notice of

Application, Investment Company Act Release No. 26,781, 70 Fed. Reg. 12,909, 12,911 n.3 (Mar. 9, 2005) (management agreement entitles the adviser to advancement of "reasonable expenses"). In many cases, therefore, the fund must pay for the costs of the adviser's defense out of fund assets. Because fund assets are nothing more than the combined investments of its shareholders, the real losers are shareholders themselves, out of whose pockets such costs ultimately come.

CONCLUSION

For the foregoing reasons, the decision of the court of appeals should be affirmed.

Respectfully submitted,

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September 3, 2009

AMICUS CURIAE BRIEF

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No. 08-586

FILED

JUN 17 2009

OFFICE OF THE CLERK
SUPREME COURT, U.S.

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR *AMICI CURIAE*, PROFESSOR DEBORAH A. DeMOTT AND PROFESSOR MARK L. ASCHER, IN SUPPORT OF PETITIONERS

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June 17, 2009

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INTERESTS OF THE *AMICI CURIAE*[1]

Amici, Deborah A. DeMott and Mark L. Ascher, are law professors who regularly teach and write about fiduciary duty in several contexts. Each has taught for more than 20 years and has written extensively in this field. Further biographical information is included in the appendix.

Amici have no stake in the outcome of this case other than their academic interest in the logically coherent development of the law. Because this case implicates fundamental issues of fiduciary duty law, *amici* believe their unique perspectives may assist the Court in its resolution of this case.

SUMMARY OF THE ARGUMENT

The law imposes fiduciary duties in response to risks of self-interested exploitation that are present in certain relationships in which the structure of the relationship makes one person vulnerable to another. Such relationships are varied, as are the specifics of fiduciary-duty doctrine, but underlying principles provide coherence. The language of § 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) (2006), which deems an investment adviser to a registered investment company "to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature," should be interpreted in light of well-developed law on the meaning and implementation of fiduciary duties in analogous relationships. The "captive" status of a registered investment company in relation

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[1] No counsel for a party authored this brief in whole or in part, and no person other than *amici* and their counsel made a monetary contribution to fund its preparation or submission. The parties have consented to the filing of this brief.

to its investment adviser, as well as structures and patterns of governance within the mutual fund segment of the financial-services industry, warrant a standard of fiduciary review that encompasses the overall reasonableness of the compensation that the investment company agrees to pay its adviser. Fiduciaries in analogous relationships are subject to duties that encompass the substance of dealings between the fiduciary and the beneficiary of the relationship. Fiduciary doctrine supplies a rich body of accumulated meaning crucial to a correct interpretation of the language of § 36(b).

Moreover, the Act expressly provides in § 36(b)(1) that "it shall not be necessary to allege or prove . . . personal misconduct" on the part of any defendant, and in § 36(b)(2) that approval of payments or compensation to an adviser by a company's independent directors, like ratification or approval by the company's disinterested shareholders, "shall be given such consideration by the court as is deemed appropriate under all of the circumstances." These statutory provisions have counterparts in well-settled bodies of fiduciary-duty law; interpreted in that light they are consistent with judicial assessment of the reasonableness and fairness of compensation paid by the company to its adviser.

The reasoning in the panel opinion below from the United States Court of Appeals for the Seventh Circuit is detached from, and in opposition to, well-established doctrine developed in analogous fiduciary relationships that should inform the interpretation of § 36(b). Moreover, the panel opinion from the Seventh Circuit misstates the law of trusts in a material respect and relies heavily on a pastiche of inapposite examples. Nor does the opinion offer

convincing policy justifications why such a major departure from settled fiduciary doctrine should apply to investment advisers that furnish services to their captive investment companies or why a court is warranted in disregarding statutory language.

ARGUMENT

I. Fiduciary duties are the law's response to risks of exploitation that stem from self-interest and that are created by the structure of certain relationships.

In relationships in which the law subjects a party to fiduciary duties, the structure of the relationship makes one party vulnerable to the other. Such vulnerability stems from the relationship, not necessarily from prior ties or dealings between the parties to the relationship, and is present when the fiduciary acts to further its own interests, as in dealings between the fiduciary and the beneficiary once their relationship has been established. Conventional categories of relationships in which actors are subject to fiduciary duties include agent-principal; trustee-beneficiary; corporate director or officer-corporation; lawyer-client; guardian-ward; and controlling shareholder-minority shareholders and corporation. In such relationships, actors subject to fiduciary duties have access to and control over property or resources of others, and, in the case of an agent, the power as a representative to affect the principal's legal position. *See* Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795 (1983); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 Vand. L. Rev. 1399 (2002); *Restatement (Third) of Agency* §§ 1.01 & 8.01 (2006).

At the core of fiduciary doctrine is the requirement that a party subject to fiduciary duties act with loyalty toward the beneficiary of the duty. Loyalty in this context proscribes self-dealing and other forms of self-advantaging conduct undertaken without the beneficiary's consent. Breach of the fiduciary duty of loyalty has long been associated with a distinctive set of remedies that strip profit or benefit from the fiduciary and that require no showing that the fiduciary's breach caused harm to the beneficiary.[2] *See* Deborah A. DeMott, *Disloyal Agents*, 58 Ala. L. Rev. 1049 (2007). Fiduciary doctrine is also distinctive because a fiduciary may breach a duty of loyalty without malign intention or even negligence. Thus, fiduciary doctrine is often characterized as prophylactic, as much geared to discourage breach as to compensate beneficiaries after a breach.[3] Its significance is not limited to after-the-fact litigation because lawyers, as advisers to clients that are subject to fiduciary duties, have professional duties to furnish counsel that is well-grounded in the law.

Fiduciary doctrine is not monolithic in its operation. Thus, the duty of loyalty applicable to some fiduciaries operates with greater stringency. Observed Professor Scott,

> Some fiduciary relationships are undoubtedly more intense than others. The greater the

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[2] *See, e.g., Phansalkar v. Anderson Weinroth & Co.*, 344 F.3d 184, 200 (2d Cir. 2003); *Restatement (Third) of Agency* § 8.02 cmt. b.

[3] *See, e.g., ABKO Music, Inc. v. Harrisongs Music, Ltd.*, 722 F.2d 988, 995-96 (2d Cir. 1983); *Boyer v. Wilmington Materials, Inc.*, 754 A.2d 881, 908 (Del. Ch. 1999).

> independent authority to be exercised by the fiduciary, the greater the scope of his fiduciary duty. Thus, a trustee is under a stricter duty of loyalty than is an agent upon whom limited authority is conferred or a corporate director who can act only as a member of the board of directors . . . .

Austin W. Scott, *The Fiduciary Principle*, 37 Cal. L. Rev. 539, 541 (1949).[4] All fiduciary actors nonetheless owe duties of loyalty to their beneficiaries, although their duties differ in relative degrees of "intensity" or stringency. Self-advantaging conduct to which a beneficiary has not consented breaches the duty because it presents the risk that the fiduciary will favor its own interests over those of the beneficiary.

Even when a beneficiary consents to a self-dealing transaction with a fiduciary, the fiduciary must act consistently with fiduciary principles. For example, when an agent obtains its principal's consent to a transaction in which the agent acts on its own behalf, the agent must act in good faith, disclose all material facts to the principal, and otherwise deal fairly with the principal. Likewise, when an agent seeks to act for more than one principal in a transaction between or among them, the agent must deal in good faith

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[4] The categories of fiduciaries identified by Professor Scott also vary in the ease with which they may be ousted by their respective beneficiaries. A principal always has power to terminate an agent's authority, even when the termination breaches terms of a contract between agent and principal. *See Restatement (Third) of Agency* § 3.10. A corporation's shareholders may have power to remove its directors, depending on provisions in the corporation's charter and bylaws and the applicable corporation statute. In contrast, beneficiaries of a trust may not so readily remove a trustee. *See Restatement (Third) of Trusts* § 78 cmt. b (2007).

with each, disclose to each the fact of the multiple representation and material facts concerning the transaction, and deal fairly with each principal. *See Restatement (Third) of Agency* § 8.06(2). A principal's consent in this context is ineffective unless it is specific to a transaction or to transactions of a particular type that could reasonably be expected to occur in the particular agency relationship. *See id.* § 8.06(1)(b). Thus, even the less stringent fiduciary constraints applicable to agents continue to have bite when the agent self-deals or undertakes multiple conflicting representations.

II. Long-settled bodies of fiduciary doctrine constitute a body of accumulated meaning that should inform the interpretation of § 36(b) of the Investment Company Act.

A general rule that furthers coherence in the law is the inference that, when Congress uses a term with "accumulated settled meaning under either equity or common law," the long-established meaning is intended unless Congress stated otherwise in the statute. *NLRB v. Amax Coal Co.*, 453 U.S. 322, 329 (1981); *see also Nationwide Mut. Ins. Co. v. Darden*, 503 U.S. 318, 322 (1992). In its enactment of the Act, Congress incorporated state law into the federal common law applicable to investment advisers. *See Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90 (1991); *Burks v. Lasker*, 441 U.S. 471 (1979). A related practice of long standing is development of the law of fiduciary duty through analogy to contexts that have comparable elements.[5]

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[5] For illustrations of this point, see *DiCarlo v. St. Mary Hosp.*, 530 F.3d 255, 268-69 (3d Cir. 2008); *CIC Prop. Owners v. Marsh USA Inc.*, 460 F.3d 670, 673 n. 1 (5th Cir. 2006);

By deeming an investment adviser "to have a fiduciary duty with respect to" its receipt of compensation for services or payments of a material nature, § 36(b) invites analysis in light of well-established fiduciary principle in other contexts. Indeed, § 36(b)(1) explicitly incorporates an element of well-established fiduciary principle by stating that proof or allegations "that any defendant engaged in personal misconduct" are unnecessary to an action for breach of fiduciary duty under the section. Proving that a fiduciary acted with the intention of inflicting an injury on the beneficiary, or that the breach of duty stemmed from negligence, is not required to allege or prove a breach of fiduciary duty.[6] Thus, although breach of fiduciary duty has long been treated as tortious, *Restatement (Second) of Torts* § 874 (1979) situates it within an uncharacterized category of miscellaneous torts, not among the torts designated as intentional or as a specialized instance of negligence.[7]

The relationship between an investment adviser and its captive mutual fund is comparable in basic and relevant respects to the relationships between (1) a trustee and trust beneficiaries, and (2) a controlling shareholder and the controlled corporation and its minority shareholders. The similarity stems from the degree to which the fiduciary actor's position is

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Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928); *see generally* Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 Duke L.J. 879, 880-82.

[6] *See, e.g., In re Baylis*, 313 F.3d 9, 20-21 (1st Cir. 2002).

[7] For analysis of breach of fiduciary duty as a tort, see Deborah A. DeMott, *Breach of Fiduciary Duty: On Justifiable Expectations of Loyalty and Their Consequences*, 48 Ariz. L. Rev. 925, 927-34 (2006).

entrenched, as well as from the relative extent of its power within the relationship. In both contexts, long-established fiduciary doctrine recognizes a principle of fair dealing that requires both full disclosure by the fiduciary and substantive fairness of the terms of any transaction when the fiduciary deals on its own behalf with the beneficiaries or its conduct is otherwise characterized as self-dealing.[8]

In both contexts, the fiduciary enjoys a well-entrenched position. As noted by the Seventh Circuit in the panel opinion in this case, "[m]utual funds rarely fire their investment advisers." *Jones v. Harris Assocs. L.P.*, 527 F.3d 627, 634 (7th Cir. 2008). Similarly, beneficiaries of a trust may not easily remove the trustee,[9] and while in office the trustee has the settlor's full title or interest in trust property unless the settlor has manifested a different intention. *See Restatement (Third) of Trusts* § 42 (2003). Likewise, a shareholder that holds sufficient voting power to elect a corporation's directors—typically also sufficient voting power to stymie fundamental transactions that require shareholder approval—is insulated from the voting power held by minority shareholders and is positioned to serve its interests to the detriment or exclusion of theirs. In both instances, as explained below, judicial review of

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[8] *See, e.g., Hardy v. Hardy*, 230 S.W.2d 11, 15 (Ark. 1950); *Equitable Trust Co. v. Gallagher*, 102 A.2d 538, 545 (Del. Ch. 1954).

[9] A trustee may be removed in accordance with terms of the trust or by court order. *See Restatement (Third) of Trusts* § 37 (2003). Beneficiaries cannot compel removal unless the terms of the trust so authorize or the beneficiaries have the power by unanimous consent to terminate or modify the trust. *See id.* cmt. b; *id.* § 65 cmt. f.

challenged transactions extends to the substantive reasonableness or fairness of transactions between the fiduciary actor and its beneficiaries.

Thus, well-established fiduciary doctrines applicable to trustees and controlling shareholders are relevant to the interpretation of § 36(b) and furnish the appropriate standard against which to assess compensation agreements between investment advisers and their mutual funds. That standard encompasses the adequacy of disclosure made by the fiduciary to the beneficiary as well as the fairness to the beneficiary of the contested transaction.

A. Trust law, trustees, and compensation

A trustee's duty of loyalty requires that the trustee "administer the trust solely in the interest of the beneficiaries, or solely in furtherance of its charitable purposes," except as otherwise provided in the terms of the trust. *Restatement (Third) of Trusts* § 78(1) (2007). However, express authorization in the terms of the trust may not sweep so broadly as to immunize from liability a trustee who "violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly," given the fundamentally fiduciary quality of a legally recognized trust relationship. *Id.* cmt. c(2).

The strict prohibition against a trustee engaging in self-dealing transactions or other transactions that stem from or create conflicts between the beneficiaries' interests and those of the trustees is subject to exceptions beyond those expressly created by the terms of the trust. *See id.* § 78(2). These include "the trustee's taking of reasonable compensation for services rendered as a trustee." *Id.* cmt. c(4); *see also id.* § 38(1) ("A trustee is

entitled to reasonable compensation out of the trust estate for services as a trustee, unless the terms of the trust provide otherwise or the trustee agrees to forego compensation."). Thus, although a trustee does not engage in prohibited self-dealing by taking compensation, the exception embraces only compensation that is "reasonable."[10] What is reasonable is not a determination left solely to the trustee to make. Additionally, by dealing directly with trust beneficiaries, the trustee breaches the duty of loyalty unless the dealings are preceded by full disclosure of material facts and are fair to the beneficiaries. *Id.* § 78(3).

1. Trustee's dealings with beneficiaries

When a trustee enters into an agreement or otherwise deals with trust beneficiaries, the trustee's dealings are subject to scrutiny under a standard that encompasses both the adequacy of the disclosure made by the trustee to the beneficiaries and the fairness of the dealings themselves. As stated in *Restatement (Second) of Trusts* § 170(2) (1959), "[t]he trustee in dealing with the beneficiary on the trustee's own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know." Likewise, *Restatement (Third) of Trusts* § 78(3) articulates the same standard of full disclosure and fair dealing: "[w]hether acting in a fiduciary or personal capacity, a trustee has a duty in dealing with a beneficiary to act fairly and to

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[10] *Accord Uniform Trust Code* § 802(h)(2) (2000) (duty of loyalty does not preclude, if "fair" to beneficiaries, "payment of reasonable compensation to the trustee").

communicate to the beneficiary all material facts the trustee knows or should know in connection with the matter."

Moreover, the same standard requiring full disclosure by the trustee and fair dealing with the beneficiary applies to agreements between trustee and beneficiary that augment the trustee's compensation beyond the amount to which the trustee would otherwise be entitled. *Restatement (Second) of Trusts* § 242 makes explicit what is implicit in the more general principle stated in § 170(2):

> The amount of compensation to which the trustee would otherwise be entitled may be enlarged or diminished by an agreement between the trustee and the beneficiary. Such an agreement enlarging the trustee's compensation, however, will not bind the beneficiary if he is under an incapacity or if the trustee failed to make disclosure of all circumstances which he knew or should have known or if the agreement is unfair to the beneficiary.[11]

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[11] *Restatement (Second) of Trusts* § 242, cmt. i. To the same effect is *Restatement (Third) of Trusts*: "[n]or will it bind a consenting beneficiary if the trustee failed to disclose all the relevant circumstances that the trustee knew or should have known, or if the agreement is unfair to the beneficiary." *Restatement (Third) of Trusts* § 38 cmt. f. For cases applying this standard, see *Fertel v. Brooks*, 832 So. 2d 297, 304 (La. Ct. App. 2002) (beneficiaries of full age and sound mind may enter into valid agreement with trustee concerning compensation, "provided the trustee displays 'the utmost good faith and fairness in the transaction'") (quoting George G. Bogert & George T. Bogert, *The Law of Trusts and Trustees* § 976 (rev'd 2d ed. 1983)); *Bowker v. Pierce*, 130 Mass. 262, 262 (1880) (finding

Thus, even if the trustee makes full disclosure of material facts to a competent beneficiary, the beneficiary's agreement to increase the trustee's compensation is unenforceable if its terms would treat the beneficiary unfairly. The applicable standard encompasses the fairness of the terms to which the beneficiary has agreed, as well as the completeness of disclosure made by the trustee.

2. Terms of trust and trustee's compensation

The terms of a trust may address the compensation to be paid to the trustee, for example by providing a formula based on the value of trust assets. That the terms of the trust would yield a particular amount of compensation for the trustee is not dispositive because fiduciary doctrine recognizes that circumstances may make such an amount unreasonable. If so, the court may reduce or augment the compensation due the trustee or permit the trustee to resign. On this point, Illustration 2 to *Restatement (Third) of Trusts* § 38 is informative:

> 2. The terms of a testamentary trust specify that the trustee is to receive annual compensation on a prescribed basis (which has proven to be fair and adequate over the years) and a termination fee set at five percent of the trust principal. The termination fee would produce what amounts to an unreasonably large sum for the circumstances of the trust,

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amount charged by trustee to be less than that contemplated by trust agreement and "clearly not exorbitant or unconscionable"); *Ladd v. Piggott*, 114 S.W. 984, 987 (Mo. 1908) (independent of compensation to which beneficiary agreed, charges by trustee "reasonable" and consistent with amounts allowed to trustees in community for similar services).

> the assets of which now entirely consist of cash equivalents and readily marketable securities worth $50,000,000. This latter figure represents a much greater appreciation in the value of the trust estate than could have been anticipated when the trustee accepted the trusteeship. The court will reduce the termination fee to the extent it concludes that the formula . . . will produc[e] an unreasonably large fee.

Thus, the amount of compensation that a trustee may be paid is subject to a limitation of "reasonableness," although the amount is specified by or derived from the terms of the trust. Nor is a change in circumstances, as in Illustration 2, the only situation in which compensation might be unreasonable.[12]

Many factors are relevant to the court's assessment of reasonableness, including, as in Illustration 2, the character of trust property relative to an amount of compensation. Also relevant are the degrees of difficulty and of risk confronted by the trustee; the trustee's skill and experience and the quality of its performance; and local custom. *See id.* cmt. c(1). Courts also consider whether the settlor may have wished to benefit the person named as trustee by structuring the trustee's compensation in part to confer a gift on the individual so named or

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[12] Illustration 2 concludes: "The court's authority to modify or disregard a compensation provision is not limited to situations involving unanticipated developments (here, the exceptional increase in corpus value) although that factor may be relevant to a court's decision."

compensate him or her for services apart from the trusteeship.[13]

To be sure, the relationship between an investment adviser and the investment company it creates is not identical to the relationship between the settlor of a trust and the trustee. For starters, it is not plausible to assume that investors in an investment company harbor donative impulses toward the company's investment adviser comparable to those a settlor may hold toward a particular individual trustee chosen by the settlor. Moreover, although a trust's settlor may also serve as its trustee or exercise control over the trustee, the starting point for any trust relationship is the settlor, not the trustee. Thus, the settlor's intention often serves as a touchstone in resolving questions that arise in the course of trust administration.[14]

In contrast, a "captive" investment company has no independent originating force comparable to the settlor of a prototypical private trust. Such a settlor is positioned to negotiate the terms of the trust instrument with the trustee on an arm's-length basis. In contrast, in the investment-company context, the beneficiary—the fund, acting through its directors —negotiates compensation with its fiduciary. The absence of an independent settlor eliminates a structural bulwark against overreaching by the fiduciary. Thus, the justification for reviewing an

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[13] *See, e.g., Estate of McClenahan v. Biberstein*, 671 N.E.2d 482 (Ind. Ct. App. 1996) (agreeing that fee paid to executor, an attorney, was justified in part because executor received no compensation for preparing estate plan).

[14] *See, e.g., Denver Found. v. Wells Fargo Bank, N.A.*, 163 P.3d 1116, 1122 (Colo. 2007); *Pack v. Osborne*, 881 N.E.2d 237, 241 (Ohio 2008).

adviser's compensation against a fiduciary standard of "reasonableness" is stronger than in the prototypical private trust, in which the applicability of the standard is well established.

Moreover, the character of judicial review in the private-trust context is informative. The court's scrutiny encompasses many circumstances. Well-established practice situates the court's application of fiduciary principles as a crucial safeguard against abuse of trust beneficiaries. Although the court may consider "local custom" in determining whether a trustee's compensation is reasonable, custom alone does not determine the answer because the court may also take into account, for example, the degree of risk and difficulty surmounted by the trustee relative to an amount of compensation.[15] Nor is it dispositive, or even relevant, that a given locale may have multiple institutional trustees keen to serve the needs of any particular settlor such that the market for trustee services could be characterized as competitive.

B. Controlling shareholders and dealings with the corporation

Shareholders that hold sufficient voting power to elect a corporation's directors and defeat proposed fundamental transactions that require shareholder approval are, like investment advisers, both entrenched in place and situated to exploit their position. Corporate law in the United States has long

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[15] *See, e.g., In re Will of McDonald*, 138 Misc. 2d 577, 579, 525 N.Y.S.2d 503, 505 (Surr. Ct. 1988) (test of reasonable fairness of compensation for fiduciary requires determination of circumstances of particular trust and services provided; commission schedules established by corporate fiduciaries not binding on court making determination of reasonable compensation).

imposed fiduciary duties on controlling shareholders. Integral to the duties' efficacy is judicial scrutiny of the fairness of a controlling shareholder's dealings with the corporation and the fairness of the price of transactions between the corporation and the shareholder, often phrased as a standard of "intrinsic" or, synonymously, "entire" fairness.[16] A controlling shareholder has the burden under this standard of showing fairness.[17]

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[16] A leading case using the "intrinsic" fairness formulation is *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). For a leading case using the synonym "entire" fairness, see *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

[17] *See Weinberger*, 457 A.2d at 710 ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts."). If a transaction has been previously approved by the corporation's disinterested shareholders, the party challenging it has the burden of showing that it constitutes a waste of corporate assets. *See Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 937 (Del. 1985). A transaction constitutes a "waste" of corporate assets if the corporation receives no consideration in exchange or receives consideration in an amount so inadequate that no person of ordinary business judgment would deem the consideration worth the corporate assets exchanged through the transaction. *See* American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations* § 1:42 (1994); *see also In re Citigroup Inc. Shareholder Derivative Litig.*, 964 A.2d 106, 138 (Del. Ch. 2009) (plaintiff in derivative suit excused from making demand on corporation's directors for claim stemming from allegations in complaint that created a reasonable doubt that terms of $68 million package to departing CEO, approved by bank's directors, constituted waste of bank's assets). In enacting § 36(b), Congress rejected the application of the waste standard to cases challenging adviser compensation. *See Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 534 n.10, 540 & n.12 (1984); 15 U.S.C. § 80a-35(b)(2) (2006).

As applied to controlling shareholders, the fiduciary standard requires examination of many factors, including those relevant to the fairness to non-controlling shareholders of a transaction's terms. In *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983), the Delaware Supreme Court formulated its influential application of the entire-fairness doctrine in the context of a merger transaction between a parent corporation and its majority-owned subsidiary that cashed out the subsidiary's minority shareholders. Although the doctrine has two components, fair dealing and fair price, "the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole." *Id.* at 711. Fair price encompasses "economic and financial considerations . . . including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock." *Id.*

Fiduciary doctrine in this context differentiates between a controlling shareholder's use of its voting rights and transactions that implicate the corporation itself and advantage the shareholder disproportionately or exclude non-controlling shareholders from participation. Jurisdictions do not identically define the transactions or activities that trigger judicial assessment against the standard of entire fairness. For example, in Delaware, a controlling shareholder has the burden of proving entire fairness only when it engages in self-dealing, defined as causing the controlled corporation to act such that the controlling shareholder receives something from the corporation to the exclusion of

non-controlling shareholders.[18] In other jurisdictions, disproportionate gains to a controlling shareholder are prima facie evidence that it has breached its fiduciary duty although those gains are unaccompanied by detriment to non-controlling shareholders. *See* James D. Cox & Thomas Lee Hazen, *Corporations* 255 (2d ed. 2003).

This fiduciary duty, implemented by the entire fairness standard, applies directly to the controlling shareholder itself. Although a corporation's directors themselves also owe fiduciary duties, well-established doctrine recognizes that the power held by controlling shareholders, like the harm it may inflict on non-controlling shareholders, is not necessarily mitigated by a corporation's directors. They may well be removable from office by the controlling shareholder and, even if nonremovable for their current terms of office, only with the controlling shareholder's support will they be reelected. Moreover, the controlling shareholder itself, but not necessarily the corporation's directors, benefits through the shareholder's unfair dealings. Fiduciary duties would lose meaning were the duty and remedies for breach inapplicable to the controlling shareholder itself.

Although jurisdictions do not define its content identically, the proposition that a controlling shareholder is subject to fiduciary duties is well-

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[18] *See Sinclair Oil*, 280 A.2d at 720 (self-dealing by controlling shareholder encompasses causing controlled corporation not to enforce output contract with controlling shareholder, but not controlled corporation's declaration of dividends in large amounts when corporation pays out same amount per share).

established.[19] Fiduciary doctrine developed in this context is relevant to interpreting the statutory fiduciary duty applicable to an investment company's adviser with respect to its receipt of compensation. Like a corporation's controlling shareholder, an investment company's adviser is well entrenched, while governance patterns in the mutual fund industry make it unlikely that the fund's directors will exercise their power to replace an adviser. *See Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 731 (7th Cir. 2008) (Posner, J. dissenting from denial of rehearing) (describing characteristics of a "captive" mutual fund).

Additionally, the incentives and interests of a controlling shareholder are not necessarily aligned with those of the corporation's non-controlling shareholders. As the merger transaction challenged in *Weinberger* illustrates, a controlling shareholder—supported by the corporation's directors, whom it elected—may be tempted to cash out the equity investment of the corporation's non-controlling shareholders at a price that does not adequately reflect the corporation's value.[20] Likewise, the incentives and interests of an investment company's advisers and its shareholders are not necessarily aligned. Indeed, fees paid to the adviser, charged to

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[19] *See, e.g., Moore v. Maine Indus. Servs., Inc.*, 645 A.2d 626, 628 (Me. 1994); *Peters Corp. v. New Mexico Banquest Investors Corp.*, 188 P.3d 1185, 1188 (N.M. 2008); *Kavanaugh v. Kavanaugh Knitting Co.*, 123 N.E. 148, 151-52 (N.Y. 1919).

[20] *See Weinberger*, 457 A.2d at 713-15 (permitting plaintiff to prove that true value of non-controlling shareholders' equity was closer to $26 per share than $21 per share, the consideration paid in merger through which controlling shareholder cashed out non-controlling shareholders' investment).

the company, constitute a substantial portion of, and in some cases the entirety of, the company's material costs of operation. Nor are an investment adviser's interests and incentives necessarily aligned with those of shareholders in its investment company through performance-driven competitive forces; performance accounts for only about 40 percent of aggregate annual growth in the mutual fund industry.[21]

Finally, a corporation with a controlling shareholder may have directors on its board who are by some definition or measure independent of the controlling shareholder, analogous to the statutory independent-director requirements applicable to investment companies.[22] Fiduciary standards and their implementation shape how lawyers advise independent directors concerning dealings with the corporation's controlling shareholder. That *Weinberger* and comparable cases permit judicial scrutiny of the substance of dealings with a controlling shareholder adds a cautionary contour to counsel's advice that would otherwise be lacking.

More importantly, courts do not treat the mere presence of independent directors on a corporation's board as dispositive when determining whether the controlling shareholder dealt fairly with the corporation. At most, isolating dealings with

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[21] *See* Investment Company Institute, *2008 Fact Book* 8 (48th ed. 2008), *at* http://www.ici.org/about_ici/annuals.

[22] *See* 15 U.S.C. § 80a-10(a) (2006) (imposing limit on registered investment companies of 60% of board members who are interested persons of company); *id.* § 80a-15(c) (requiring approval of investment adviser's contract by vote of majority of directors who are not parties to agreement or interested persons.).

the controlling shareholder in a committee of independent directors who have credible power to negotiate, to reject any deal, and to retain their own independent legal and financial advisers shifts the burden on fairness to the party who challenges the transaction.[23] In contrast, provisions in corporation statutes may insulate from attack transactions between a corporation and one or more of its own directors when such self-dealing transactions are approved by disinterested directors who know the material facts and act in good faith.[24] Underlying the difference in treatment are the realities of power and influence when the corporation's directors serve at the behest of the party—the controlling shareholder —that will be the counterparty in transactions that the directors are charged with evaluating.

The specifics of power and influence held by an investment adviser vis-à-vis its investment company are not identical to those present in relationships between controlling shareholders and their corporations. It is the investment company's shareholders, not its adviser, who elect its directors. But the directors are chosen by the adviser or by incumbent directors, making shareholder suffrage more a theoretical than a practical constraint. Moreover, governance patterns

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[23] *See Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997) (controlling shareholder has burden of proving entire fairness unless it can prove an independent committee negotiated an arguably self-dealing transaction, meaning that "the committee . . . function[ed] in a manner which indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power 'at an arms length'") (quoting *Rabkin v. Olin Corp.*, C.A. No. 7547, 1990 WL 47648 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990)).

[24] *E.g.*, Del. Code Ann. tit. 8, § 144 (1998).

in the mutual fund industry may suggest that softer forms of power and influence could be operative for some directors,[25] ones usefully offset by counsel's advice about the demands of fiduciary duty and by the prospect of substantive judicial assessment of transactions with the company's investment adviser.

Additionally, the Investment Company Act itself treats investment advisers as comparable to controlling shareholders. Section 36(b), by imposing a direct fiduciary duty on advisers with respect to the receipt of compensation and material payments, makes relevant the body of fiduciary principles applicable to controlling shareholders, including the entire fairness standard.

III. The Seventh Circuit's interpretation of the Act disregards accumulated doctrinal meaning and ignores significant provisions of the Act.

The Seventh Circuit's account of fiduciary duties, minimal at best, is misleading. The panel opinion below ignores well-established bodies of fiduciary doctrine that require judicial assessment of the substance of dealings between fiduciaries and their beneficiaries. The court's assertion that "[j]udicial price-setting does not accompany fiduciary duties"[26] also ignores well-established fiduciary doctrine applicable to contexts similar in relevant respects.

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[25] For example, service by individual directors on multiple funds within the same fund "family" is a common practice. *See Krantz v. Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140, 143-44 (3d Cir. 2002) (holding that practice is not a basis on which to overcome presumption created by 15 U.S.C. § 80a-2(a)(9) (2006) that a natural person is disinterested).

[26] *Jones*, 527 F.3d at 633.

albeit not identical to, the investment company setting.

A. General disregard of accumulated doctrinal meaning

The description of fiduciary doctrine earlier in this brief is neither innovative nor controversial. Additionally, the rationales for imposition of fiduciary duties are well-established. The Seventh Circuit's opinion furnishes no general account of fiduciary duty or the rationales that support its imposition. Perhaps for that reason the court's opinion ignores settled and broadly applicable principles that are integral to the meaning of statutory language deeming a party "to have a fiduciary duty." Instead, the court's opinion relies on a series of isolated examples that do not support the conclusion it reaches.

B. Trust law

1. Inapposite focus

The Seventh Circuit's treatment of trust law focuses on terms in a trust instrument through which a settlor specifies the trustee's compensation. *See Jones*, 527 F.3d at 632. This focus is inapposite to the mutual fund context because the fund's origin is not traceable to an independent counterpart to a settlor able to negotiate on an arm's-length basis with a prospective fiduciary, as discussed in Part II.A. Instead, the correct analogy within trust doctrine is to a trustee's dealings with its beneficiaries, discussed in Part II.A.1. When dealing with a trust's beneficiaries, the trustee's fiduciary duty requires that it make full disclosure of relevant circumstances and that the terms of the transaction be fair to the beneficiaries. *See Restatement (Second) of*

Trusts § 170(2). In particular, an agreement between beneficiaries and the trustee augmenting the trustee's compensation does not bind the beneficiaries if the trustee has dealt unfairly with them by failing to disclose all material circumstances or if the agreement itself is unfair to the beneficiaries. *See id.* § 170 cmt. i; *supra* Part II.A.1.

2. Inaccuracy

Additionally, the Seventh Circuit's treatment of trust-law principles is inaccurate. The panel opinion cites *Restatement (Second) of Trusts* § 242 and Comment f for the proposition that "a trustee owes an obligation of candor in negotiation, and honesty in performance, but may negotiate in his own interest and accept what the settlor or governance institution agrees to pay." *Jones*, 527 F.3d at 632. However, Comment f to § 242, entitled "*The terms of the trust*," says nothing about provisions for trustee compensation that may be challenged as excessively large. Comment f does, however, address the opposite possibility:

> If the amount of compensation provided by the terms of the trust is so inadequate that no duly qualified person would be willing to act as trustee for the compensation so provided, the court may authorize a larger compensation, since otherwise the purposes of the trust would be defeated or substantially impaired.

Restatement (Second) of Trusts § 242 cmt. f. Indeed, the black letter principle stated by § 242 itself is only that "the trustee is entitled to compensation out of the trust estate for his services as trustee, unless it is otherwise provided by the terms of the trust or unless he agrees to forego or waives compensation."

This statement does not cover the terrain necessary to ground the Seventh Circuit's assertion. That the intent of § 242's Comment f was limited to trustees who seek compensation in addition to that provided by the terms of the trust is confirmed by *Restatement (Third) of Trusts* § 38, Reporter's Note to Comment c, which observes that *Restatement (Third)*'s provision is "more favorable to such claims" in which trustees seek additional compensation than was Comment f. Indeed, controversy associated with the counterpart provision in the *Uniform Trust Code* (2000) appears to have focused solely on the prospect that the court's power would encompass increasing a trustee's compensation; that the court could decrease unreasonably high compensation was uncontroversial.[27] And, as Part II.A.2 of this brief demonstrates, *Restatement (Third) of Trusts* contemplates circumstances—furnishing a specific illustration—in which fiduciary principles warrant reducing the amount of a trustee's compensation despite its consistency with terms of the trust.

Additionally, the Seventh Circuit's account is uninformed by trusts statutes. Under the *Uniform Trust Code* § 708(b), "[i]f the terms of a trust specify the trustee's compensation, the trustee is entitled to compensation as specified, but the court may allow

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[27] *See* David M. English, *Representing Estate and Trust Beneficiaries and Fiduciaries*, SJ001 ALI-ABA 285 (2003) (commenting on *Uniform Trust Code* § 802 and reporting that "[t]he dispute is not over whether the court should be able to adjust compensation that is unreasonably high" but, "[r]ather, the objection is to the court's authority to adjust compensation that is unreasonably low" and that "[t]hose taking this view concluded that the trustee should be held to its badly made bargain"). Professor English served as the Reporter for the *Uniform Trust Code*.

more or less compensation if . . . (2) the compensation specified by the terms of the trust would be unreasonably high or low." *Uniform Trust Code* § 708. Apart from the Code, to the same effect are statutes in leading jurisdictions.[28]

C. Inapposite examples

1. Executive compensation

The Seventh Circuit's opinion also relies on a series of examples that are either inapposite or that fail to support the court's argument in other respects. The court points to compensation practices in business corporations as another instance of the superiority of "[c]ompetitive processes" to a "'just price' system administered by the judiciary." *Jones*, 527 F.3d at 633. As the court describes compensation practices for publicly-traded corporations: "a committee of independent directors sets the top managers' compensation. No court has held that this procedure implies judicial review for 'reasonableness' of the resulting salary, bonus, and stock options." *Id.* Notably, other members of the same court are not so sanguine about public-company compensation practices, the outcomes they produce, and the governance patterns that underlie them.[29]

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[28] *See* Cal. Prob. Code § 15680(b)(2) (2009); Del. Code Ann. tit. 12, § 3560(a) (1989) (Court of Chancery may allow greater or lesser compensation when, *inter alia*, "the compensation in accordance with the terms of the trust would be unreasonably low or high").

[29] *See Jones*, 537 F.3d at 730 (noting the "feeble incentives of boards of directors to police compensation," compensation-related incentives of CEOs who serve as directors of other companies, and conflicted position of compensation consulting firms "which provide cover for generous compensation packages

Flawed (or not) as they may be, public-company compensation practices are not useful as a point of analytic departure for interpreting § 36(b). Congress explicitly deemed investment advisers to have a fiduciary duty in connection with their receipt of compensation and other material payments. No comparable legislative declaration applies to executives' receipt of compensation payments, even in public companies registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934. Additionally, the relative significance of executive compensation pales in contrast to advisers' fees in the investment company context. No publicly traded company's compensation payments, however lavish, amount to such a substantial portion of its cost of carrying on the corporate enterprise, while the compensation that an investment company pays to its adviser is its greatest cost.

The Seventh Circuit's executive-compensation example is also inapposite because it slights the weakness with which corporate executives (individually or as a group) are entrenched in any particular company compared to a mutual fund's investment adviser. Although many senior executives are not employees at will,[30] turnover in executive ranks is a visible phenomenon. Contracts between

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voted by boards of directors" because the firms furnish services apart from compensation consulting to the same clients, for which they are retained by officers on whose compensation packages they advise).

[30] *See* Stewart J. Schwab & Randall S. Thomas, *An Empirical Analysis of CEO Employment Contracts: What Do Top Executives Bargain For?*, 63 Wash. & Lee L. Rev. 231, 233 (2006).

senior executives and their employers price the cost to the company of effecting an early termination of the relationship without showing cause. In contrast, turnover among investment advisers is acknowledged to be rare. Thus, to the extent the Seventh Circuit's reasoning relies on "competitive processes," on this point of comparison such processes operate without leaving visible traces in the mutual fund context.

2. Lawyers' fees

The Seventh Circuit also identifies lawyers as actors who owe fiduciary duties to clients "but are free to negotiate for high hourly wages or compensation from any judgment." *Jones*, 527 F.3d at 633. If a client contests a fee, the question for the court is whether the client's choice was made voluntarily and on an informed basis. *Id.* Judicial fee-setting, in settings where it occurs, follows the market. *Id.* This example, like the court's executive compensation example, again ignores the statutory designation of investment advisers as fiduciaries in relationship to their receipt of compensation and other material payments, a designation without a statutory counterpart applicable to lawyers.

Additionally, in only a purely formal sense would a client owe its existence to its lawyer's entrepreneurial effort. Clients—even business firms originally formed by a lawyer—frequently change counsel. An investment company, in contrast, originates with its investment adviser, and their relationship almost always persists.

Markets for legal services also differ in major ways from the market among mutual funds for investment advice. Lawyers compete on the basis of fees, a form of competition that leads to shifts in

clients' allegiances, both phenomena not observed in relationships between mutual funds and their investment advisers.

Finally, to claim as did the Seventh Circuit that courts merely "follow the market" in making fee determinations slights the complexity of that task. It also ignores the fact that, in some contexts, courts do determine the "reasonableness" of fees. Courts review the reasonableness of fees to be paid to class counsel in class-action litigation and, in the probate setting, the reasonableness of all fees paid to counsel for executors, guardians, and conservators, as well as fees paid to attorneys *ad litem*. In the corporate context, directors and officers who are entitled under corporation statutes to receive indemnification for litigation-related expenses, including attorney's fees, have a claim only for expenses that were "reasonably incurred." *E.g.*, Del. Code Ann. tit. 8, § 145 (2006). In determining whether fees were reasonably incurred, the court may consider whether the particular counsel chosen by the person seeking indemnification—or, more often, enforcement of a right to advancement prior to a final determination of the person's entitlement to indemnification—represented a "reasonable" choice.[31] Justifying some measure of review of reasonableness by the court is the fact that the person seeking indemnification or advancement will, if the quest succeeds, be spending the corporation's money, not his or her own.[32]

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[31] *See Westar Energy, Inc v. Lake*, 552 F.3d 1215, 1227-28 (10th Cir. 2009).

[32] When a corporation has an enforceable obligation to advance the costs of defense to a person pending ultimate determination of the person's entitlement to indemnification, all

Similarly, directors of an investment company use the company's—their shareholders'—assets to pay compensation to the company's investment advisor, a point ignored by the Seventh Circuit. The narrowness of the Seventh Circuit's analytic framework, like the meagerness of its examination of the examples it chose to use, produced a misleading treatment of fiduciary duty, even when discussion is limited to the court's chosen (and inapposite) examples.

CONCLUSION

The judgment of the United States Court of Appeals for the Seventh Circuit should be reversed.

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the monies expended may be the corporation's, regardless of the outcome of the ultimate determination.

APPENDIX

More detailed biographical information about each of the *amici* is as follows:

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AMICUS CURIAE BRIEF

(23)

No. 08-586

In the Supreme Court of the United States

JERRY N. JONES, ET AL.,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF FOR FIDELITY MANAGEMENT & RESEARCH COMPANY AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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QUESTION PRESENTED

Amicus Curiae Fidelity Management & Research Company will address the following questions:

1. Whether the plain language and structure of the Investment Company Act ("ICA"), as confirmed by legislative history, show that Congress intended courts considering Section 36(b) claims to give substantial deference to the business judgment of fund directors concerning the level of fees paid to a fund's investment adviser.

2. Whether the principles set forth in *Gartenberg* and updated in *Jones* to reflect significant changes in the mutual fund industry and its regulation during the past three decades—including increased competition and disclosure and more searching fee evaluation by fund directors—provide the appropriate standard by which to judge claims under Section 36(b) and require affirmance of the district court's and Seventh Circuit's decisions.

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INTEREST OF THE *AMICUS CURIAE*

Amicus Fidelity Management & Research Company (together with its affiliated entities, "Fidelity") has acted since its founding in 1943 as the investment adviser to the Fidelity family of mutual funds.[1] Fidelity—a privately held international provider of financial services for individuals and institutions managing over $1.3 trillion in assets—offers more than 300 mutual funds, including some of the world's largest. Fidelity also offers brokerage, financial planning, wealth management, and securities trading services. It reinvests billions of dollars each year into improving products and services for investors using state-of-the-art infrastructure and technology, and is consistently recognized for providing some of the highest levels of customer support in the industry.

Fidelity provides investment management services (portfolio management, research, and trading) and a range of shareholder and administrative services to Fidelity funds under Management Agreements reviewed and approved by fund boards of directors annually. Fidelity provides additional services to Fidelity funds under separate transfer agent, distribution, and pricing and bookkeeping agreements, which are also reviewed and approved annually by fund boards.

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[1] No counsel for any party authored this brief in whole or in part and no person other than *amicus* and its counsel made a monetary contribution to its preparation or submission. The parties' consents to the filing of this brief are on file with the Clerk.

Fidelity and the directors of Fidelity funds take seriously their responsibilities concerning Management Agreements, including adviser fees. *All* members of the fund boards' Operation Committees that review these agreements are independent of Fidelity. Between 71% and 83% of the funds' full boards have been independent directors in recent years. Those boards comprise former executives of major corporations and senior figures from government, financial services, and accounting, who receive training specific to fund oversight and contract issues. Boards obtain information relevant to their consideration of Management Agreements not only from Fidelity, but also from third-party auditors and services, and they are advised by independent counsel. Contract review is a year-round process. It involves numerous conversations, presentations, and discussions between trustees and Fidelity, as ICA Section 15(c) contemplates.

Fidelity is keenly interested in the interpretation of Section 36(b). Despite offering fees among the lowest in the industry and state-of-the-art service, Fidelity has faced Section 36(b) suits, including, currently, *Bennett* v. *Fidelity Management & Research Company*, No. 04-CV-11651 (D. Mass.). Fidelity speaks with experience of the costs and disruption those suits cause, the adverse impact of expansive liability rules on fund governance, and the ease with which any fund can be targeted with speculative and legally irrelevant economic comparisons in such cases. Fidelity believes its views as a leader in the mutual fund industry will assist the Court in this case.

SUMMARY OF ARGUMENT

I. Statutory language and structure—confirmed in the legislative history and reflected in decades of judicial decisions and SEC pronouncements—show that Congress intended courts to give substantial deference to the judgment of fund boards and to create a private cause of action only for fees "so unusual" or "so disproportionate" that they could not have been the outcome of arm's-length bargaining. A fund board is entitled to exercise its business judgment as to the approval of appropriate fees, and judicial deference is warranted when it does so.

II. Deference to the business judgment of fund boards extends to a judgment that fees are appropriate even though the adviser's fees to institutional clients, such as pension funds, are lower. Services provided to mutual funds are inherently different from and significantly more costly than the limited services that institutional clients require.

Attempting to isolate fees for particular services for direct comparison would mire courts in intractable economic disputes that could be resolved only by arbitrary assignments of value and cost. Efforts to place a value on advisers' services would inevitably result in courts engaging in vague reasonableness or fairness inquiries, or in cost-plus ratemaking, both of which Congress prohibited. A plaintiff can always find an expert to take its side in disputes about an adviser's fees for components of services that the adviser offers only on a bundled basis, or about what costs should be allocated to specific fund services. Including those inquiries as part of the Section 36(b) cause of action would invite

suits against *every* fund after *every* annual contract review—something Congress did not intend.

III. Plaintiffs' contention that "captive" fund boards require close judicial supervision is refuted by vigorous competition among funds. With more than 8000 funds competing for retail investors—who can readily switch between funds or to other investment vehicles—there can be no doubt that a fund with high fees relative to performance and services would find it extremely difficult to attract or retain investors. Fee levels have responded to competition, which constrains fees regardless of whether funds replace their investment advisers.

In this highly competitive environment, in which the SEC actively oversees relations between funds and advisers, superimposing open-ended common law standards onto Section 36(b) is unnecessary to protect investors. To do so would contradict the intent of Congress that the provision establishes *federal* fiduciary duty standards attuned to the particular circumstances of mutual fund governance. Beyond this, relevant common law principles do not support the sort of remote comparisons or open-ended reasonableness inquiry plaintiffs advocate. Nor is there any support in the text or history of the ICA for the proposition that Section 36(b) creates a cause of action, separate from fee levels, for alleged deficiencies in an adviser's disclosure to a fund board—a theory unlike any securities liability Congress ever created.

IV. An open-ended Section 36(b) inquiry would encourage litigation against every fee, based on loose economic comparisons and speculation about other information that advisers might have provided. It

has the potential to turn every fee agreement into a lengthy dispute in federal court with no standards to resolve the matter early in the litigation or to guide appellate review, ratcheting up the pressure on advisers to settle regardless of the merits. It would leave advisers at constant risk of judge-ordered retroactive fee changes, interfere with efficient business operations, heap expense on shareholders, and deter service on fund boards. This Court has refused to impose standards that have such adverse effects. By contrast, a standard focused on the elements identified in Section 36(b)—exercise of business judgment, and the level of compensation for services—promotes early disposition of weak suits. Affirming the judgment would provide courts with important guidance in applying the governing law.

ARGUMENT

I. SECTION 36(b) CREATES A NARROW CAUSE OF ACTION FOR FEES THAT COULD NOT HAVE RESULTED FROM ARM'S-LENGTH BARGAINING.

For nearly 30 years courts have interpreted Section 36(b) to mean that a plaintiff must prove that an adviser's fee is "so disproportionately large" given "services rendered" that it "could not have been the product of arm's-length bargaining." *Gartenberg* v. *Merrill Lynch Asset Mgmt.*, 694 F.2d 923, 928 (2d Cir. 1982). The Seventh Circuit, stating a standard different only in subtleties, recognized that compensation must be "so unusual" as to suggest that fund trustees abdicated their responsibilities. Pet. App. 9a. This focus on whether a fee could have been the product of the contract review process contemplated by ICA Section 15(c) is the only

interpretation congruent with the statute's language and history.

A. Statutory Text, Structure, And History Show Congress Intended A Narrow Cause Of Action For Fees That A Board Acting At Arm's-Length Could Not Have Approved.

1. Section 36(b) provides a carefully circumscribed private remedy for excessive fees. In private suits, Congress declared that an investment adviser has a "fiduciary duty with respect to *the receipt of compensation for services.*" By contrast, in Section 36(a) Congress laid down a more expansive fiduciary obligation enforceable only by the SEC.

Subsection (b)(3) further specifies that a private cause of action lies only against "the recipient" of the "compensation," and it limits recovery to "actual damages" during one year prior to filing of the suit, capped at "the amount of compensation" received. To minimize strike suits, Congress placed the burden of proof on plaintiffs. A court's inquiry into excessiveness is focused by Subsection (b)(2), which provides that approval of an adviser's compensation by a fund's board of directors "shall be given such consideration by the court as is deemed appropriate under all the circumstances."

Additional guidance as to when deference to the board's approval of a fee is appropriate comes from Section 15(c), which sets out key responsibilities with respect to Management Agreements, including compensation provisions. A majority of the *independent* directors of a fund must approve the adviser's fee. And it is the duty of fund directors "to request and evaluate, and the duty of an investment adviser

* * * to furnish, such information as may reasonably be necessary to evaluate" the fee. Provided that a board obtains information it deems necessary, and evaluates the fee in light of that information, its approval of the fee is entitled to substantial deference. As this Court has held, board approval must be given "serious consideration by the court in a § 36(b) action." *Daily Income Fund* v. *Fox*, 464 U.S. 523, 540 (1984); see Rogers & Benedict, *Money Market Fund Management Fees: How Much is Too Much?*, 57 N.Y.U. L. Rev. 1059, 1124 (1982) ("Responsibility for determining the fairness" of a fee rests primarily with the "good faith judgment" of the "board of directors").

2. Legislative history confirms that Congress intended courts to evaluate fee claims through the prism of the board's business judgment. This Court concluded in *Burks* v. *Lasker*, 441 U.S. 471, 484-485 (1979), that "Congress' purpose in structuring the [ICA] as it did" was "to place the unaffiliated directors in the role of 'independent watchdogs'" with "primary responsibility for looking after the interests of the funds' shareholders," including their interest in not paying excessive fees. See S. Rep. No. 91-184 (1969), 1970 USCCAN 4897, 4903 (describing fund directors' "important role in the management fee area"). Section 15(c) ensures that "the attention of the directors" is "fixed on their responsibilities." *Ibid.*

Congress made clear that it did "not inten[d] [Section 36(b)] to shift the responsibility for managing an investment company" from the board of directors "to the judiciary." *Id.*, 1970 USCCAN at 4903. To the contrary, the statute preserved "the authority and responsibility of directors," and specifically was "*not intended to authorize a Court to*

substitute its business judgment for that of the mutual fund's board of directors in the area of management fees." *Id.*, 1970 USCCAN at 4902-4903 (emphasis added).

Elaborating on the statutory language, the Senate and House Committee Reports explain how a court should determine whether deference is due to the board's business judgment: by "evaluat[ing] whether the deliberations of the directors were a *matter of substance* or *a mere formality*." *Id.*, 1970 USCCAN at 4910 (emphasis added); H.R. Rep. No. 91-1382, at 37 (1970) (same). That inquiry might not ultimately be "controlling" in every case—for example, a fee itself might be "so disproportionate" or "so unusual" as to suggest the process had broken down. S. Rep. No. 91-184, 1970 USCCAN at 4910; see Pet. App. 9a. But Congress intended a court's focus to be on whether the board made a "*responsible determination* regarding the management fee," in contrast to just rubber-stamping the fee request. S. Rep. No. 91-184, 1970 USCCAN at 4903 (emphasis added). It is that inquiry—as well as the fact that Section 36(b) "established new enforcement mechanisms"—that makes Section 36(b) not "superfluous" to Section 15(c). U.S. Am. Br. 14-15.

3. Accordingly, courts have recognized since *Gartenberg* that approval by an independent board is the single most important factor in evaluating a claim under Section 36(b) and "militates strongly against the contention that the advisors have breached their fiduciary duty to the funds or their shareholders." *Green* v. *Fund Asset Mgmt., L.P.*, 147 F. Supp. 2d 318, 332 (D.N.J. 2001), aff'd, 286 F.3d 682 (3d Cir. 2002); accord *Schuyt* v. *Rowe Price Prime Reserve Fund, Inc.*, 663 F. Supp. 962, 988

(S.D.N.Y.) (board approval to be "weighted heavily"), aff'd, 835 F.2d 45 (2d Cir. 1987); *Krinsk* v. *Fund Asset Mgmt., Inc.*, 715 F. Supp. 472, 501 (S.D.N.Y. 1988) (courts "will not ignore a responsible decision by the Trustees"), aff'd, 875 F.2d 404 (2d Cir. 1989); Pet. App. 8a, 13a-14a; *Gartenberg*, 694 F.2d at 930 (board approval among the most "important factors").

B. SEC Regulations Confirm That A Board's Business Judgment Warrants Substantial Deference.

On the business judgment issue, the SEC has now changed its tune. Despite its support for plaintiffs here, the SEC previously advised this Court that "shareholder protection" is achieved by deferring to the "business judgment" of independent directors, stating that any other approach would evidence "a failure to give proper consideration to the structure and purposes of the Act." U.S. Am. Br. in *Burks*, 1978 WL 207114, at *2-*3, *7-*9; see *id.* at *2-*3 ("the congressional goal of active stewardship by disinterested directors" is "achieved by applying the traditional business judgment rule within a framework of safeguards" supplied by Section 15(c)); *id.* at *9 ("The business judgment rule" is one of "shareholder protection and should not lightly be discarded"). See also Paul Roye, Director, SEC Div. of Inv. Mgmt., *What Does It Take to Be an Effective Independent Director of a Mutual Fund* (Apr. 14, 2000) ("court will not substitute its judgment" for that of the board).

Indeed, since 1970 the SEC has strengthened the statutory protections for investors in Sections 15(c) and 36(b) through regulations effectively mandating that independent directors constitute at least 50% of the board and select other independent directors,

and requiring independent legal counsel. 66 Fed. Reg. 3734, 3758-3759 (2001). In fact, most boards, like those of the Fidelity funds, comprise about 75% independent directors. These rules "have led to stronger, more independent" fund boards, "better equipped to deal" with "oversight of fund expenses." Paul Roye, Director, SEC Div. of Inv. Mgmt., Memo. in Response to Correspondence from Rep. Baker, June 9, 2003, at 49, available at http://tinyurl.com/m3ohoj.

The SEC also has elaborated on the factors related to fees that should be considered by the board, and requires that the basis of the board's decision be disclosed to shareholders. 17 C.F.R. § 240.14a-101, Item 22(c)(11); *id.* Part 274. It also mandates that fees be prominently disclosed, in plain English, in the prospectus. SEC Form N-1A. This "[i]ncreased transparency," the SEC has said, encourages "boards to engage in vigorous and independent oversight of advisory contracts." *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, ICA Release No. 26,486 (June 23, 2004).

And, of course, the SEC has the power to enforce duties regarding review of Management Agreements. It conducts regular 15(c) "audits" and files administrative proceedings when necessary. See *In re N.Y. Life Inv. Mgmt. LLC.*, ICA Release No. 28,747, at 7 (May 27, 2009) (Section 15(c) violation by adviser). A statement by the SEC that a board's or adviser's actions were inadequate would have impact across the industry and remedy any general failing the SEC perceived.

In this regulatory environment, judicial deference to the business judgment of a board is

especially appropriate. See SEC Div. of Inv. Mgmt., *Report on Mutual Fund Fees and Expenses* 6 (Dec. 2000) ("primary reliance on disclosure and procedural safeguards to determine mutual fund fees" is "sound and operates in the manner contemplated by Congress"); SEC Div. of Inv. Mgmt., *Protecting Investors: A Half Century of Investment Company Regulation* 253 (1992) (the "'watchdog' function" performed by independent directors has "served investors well").

II. A COURT SHOULD NOT SECOND GUESS A BOARD'S BUSINESS JUDGMENT CONCERNING THE RELEVANCE OF FEES CHARGED TO INSTITUTIONAL CLIENTS.

Plaintiffs barely mention fund boards, except to denigrate them as "captive"—a charge contradicted by statutory and regulatory provisions promoting independent business judgments, by elaborate and effective systems for review of fees established in response, and by the vigorously competitive nature of the modern fund industry. See Part III.A, *infra*. Instead, plaintiffs' proposed inquiry begins and ends with an apples-to-oranges comparison between fees paid by mutual funds and those paid by institutional clients, such as pension funds.

According to plaintiffs, a fund board's determination that such a comparison is uninformative, or that fee differences are justified, is besides the point; the court in a Section 36(b) suit must undertake its own inquiry, second-guessing the board's decision. Compare U.S. Am. Br. 30 (citing SEC and other sources stating that *fund boards* may wish to consider fees charged for institutional products). Plaintiffs' approach invites litigation against every

fund fee, because advisers' fees to institutional clients are usually lower. *E.g.*, Collins, *The Expenses of Defined Benefit Pension Plans and Mutual Funds*, ICI Perspective 9 (Dec. 2003). Indeed, it is precisely because this differential is almost universal that trial lawyers want to make it a litmus test under Section 36(b). The comparison plaintiffs advocate is false, and it would lead courts into a quagmire with no standards to judge plaintiffs' claims.

A. Mutual Fund And Institutional Fees Are Not Comparable.

The SEC acknowledges that "[t]he comparison to fees paid by unaffiliated institutional clients * * * raises the question whether the services provided to different kinds of entities [are] in fact comparable." U.S. Am. Br. 31 n.10. They are not. See Coates & Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 185 (2007) ("retail and institutional customers consume different services or differ in the underlying cost of generating services"). For example:

- Retail mutual funds are subject to statutory and regulatory requirements that are inapplicable to institutional products, including detailed requirements of the Securities Act, Securities Exchange Act, Investment Advisers Act, and ICA. The resulting legal obligations—including complying with the Sarbanes-Oxley Act, retaining independent trustees and a chief compliance officer, making prospectus disclosures, and conducting shareholder meetings—provide investor protections, but come at a big price. Compliance costs are far lower for institutional products.

• Advisers provide a broad array of services to thousands (even millions) of mutual fund shareholders. These services commonly include preparing disclosure documents, providing investment guidance and education, developing retirement plans, operating investor centers, call centers, and websites, performing transfer agency services, and providing account statements and dividend and tax reporting. Advisers must make significant investments in the infrastructure necessary to provide these services. Most of these services are not given to institutional clients, which generally contract only for basic investment advisory services, principally stock selection. For example, institutional clients do not use an investment adviser's costly telephone representatives or investor centers.

• The vastly different size of retail and institutional accounts means that the adviser's transaction costs for mutual funds are dramatically higher. The average account size in Fidelity mutual funds is approximately $12,000, while institutional accounts average more than $50 million. Providing record keeping, transfer, and other services is substantially more costly for numerous small accounts than for a small number of large accounts.

• Advisers face far greater entrepreneurial risks with retail mutual funds. An institutional account begins life when a single client invests millions of dollars. By contrast, an adviser starting a retail mutual fund typically uses its own money as capital and works to build an investor base over time—often at a loss until the fund reaches a breakeven level of assets, which can take years and may never happen. The adviser must constantly market funds to offset redemptions.

• Investors can redeem their shares in retail mutual funds on a daily basis, resulting in unpredictable daily cash flows in and out of the fund. Institutional customers require cash flow only a handful of times per year and typically provide the adviser advance notice. The need to meet daily cash flow requirements makes portfolio management of mutual funds more difficult and costly than management of institutional products—a fact plaintiffs concede when they acknowledge that money market funds are not comparable to institutional accounts precisely because of such cash flow differences. Pet. Br. 30.

In light of differences like these in the services provided to the two types of clients, courts have rejected the argument that fees charged to institutional clients are relevant when considering mutual fund adviser compensation. The Second Circuit explained that the "nature and extent of the services required by each type of fund differ sharply." *Gartenberg*, 694 F.2d at 930 n.3. The Seventh Circuit recognized too that "[d]ifferent clients call for different commitments of time." Pet. App. 13a. Virtually every court to have considered the issue agrees.[2]

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[2] *E.g.*, *Strougo* v. *BEA Assocs.*, 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002) ("relevant comparison" is "to other mutual funds, not to non-mutual fund institutional clients"); *In re AllianceBernstein Mut. Fund Excessive Fee Litig.*, 2006 WL 1520222, at *2 (S.D.N.Y. May 31, 2006) ("fee differential reflects * * * different services provided" and "different liabilities assumed"); *Schuyt*, 663 F. Supp. at 974 n.38 (services provided "to the Fund and [institutional] clients differ substantially"); *In re Evergreen Mut. Funds Fee Litig.*, 240 F.R.D. 115, 122

B. Isolating Portfolio Management Fees Is Economically And Legally Improper.

Plaintiffs contend that these differences can be disregarded if a court limits its inquiry to the "portfolio management" component of an adviser's fee. Pet. Br. 50; Econ. Am. Br. 23. But that narrower focus makes the proposed comparison no more viable or appropriate.

In many cases, there is no stand-alone charge for mutual fund portfolio management to which institutional portfolio management prices can be compared. Fund advisory contracts often cover shareholder and administrative services not provided to institutional clients. See SEC Div. of Inv. Mgmt., *Report on Mutual Fund Fees and Expenses* Part III.B.1 & n.60 (Dec. 2000). For Fidelity's Magellan Fund, for example, Fidelity's management fee covers not only portfolio management, but also maintaining shareholder relations (through more than 100 investor centers, a 24/7 call center, and a state-of-the art web site, and by providing investor education), supervising relations with numerous third parties, providing ICA regulatory compliance, and furnishing reports and analyses to fund trustees, among others. Fidelity Magellan Fund 2009 Statement of Additional Information, "Management Contract" (May 30, 2009). Accordingly, the two charges cannot be compared because they are for different services.

When an investor buys a mutual fund, the investor buys the whole package of services: the account statements, website, phone center, and

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(S.D.N.Y. 2007) ("comparisons [to institutional account fees] are not necessarily informative").

compliance infrastructure, along with investment management. For that reason, courts have recognized the need to evaluate the totality of fees and services, not just isolated components. *E.g.*, *Gartenberg*, 694 F.2d at 930 ("all services rendered to the fund or its shareholders" must be considered) (quoting S. Rep. No. 91-184, 1970 USCCAN at 4910); Pet. App. 13a; *Krinsk*, 715 F. Supp. at 498 (issue is whether different fee components "in combination, amoun[t] to a breach of fiduciary duty"); *Benak* v. *Alliance Capital Mgmt.*, 2004 U.S. Dist. LEXIS 12231, at *25 (D.N.J. Feb. 9, 2004) ("it is the overall nature and quality of the services provided by the investment adviser that is at issue"). As Judge Pollack explained in *Gartenberg*, what counts is "the totality of the values placed at the disposal of the shareholders." 528 F. Supp. at 1052. For that reason, benefits provided to investors under *other* contracts are also "a 'surrounding circumstance'" that "would pervade all aspects of a hypothetical arms' length negotiation over the Fund's advisory fee." *Krinsk*, 715 F. Supp. at 486; see also *id.* at 481-482.

That approach is required by the statute. Section 36(b) provides that an action may be asserted against an "investment adviser or any affiliated person" with respect to compensation received "for services," expressing Congress's intent that courts consider *all* compensation received by the adviser and its affiliates and *all* services they render. Congress expected courts to "look at * * * *all services rendered* * * * and *all compensation and payments received*, in order to reach a decision as to whether the adviser has properly acted as a fiduciary." S. Rep. No. 91-184, 1970 USCCAN at 4910 (emphasis added).

Any effort to segregate fees for mutual fund portfolio management in order to compare them to institutional portfolio management charges is certain to produce arbitrary results. Different advisers and fund boards allocate costs and revenues differently among the various elements of integrated services, most of which are joint-and-common across many funds. Some services to a mutual fund may be provided at cost, or even at a loss, with profits taken on other services, and advisers vary in how they make these accounting allocations across services and across funds. These allocations are "an art rather than a science" (*Krinsk*, 715 F. Supp. at 489), with the range of reasonable allocations being large. In consequence, allocated cost and profit data—inevitably at the heart of plaintiffs' proposed comparison—has very little economic meaning and should have no role in Section 36(b) litigation. See Pet. App. 13a ("Joint costs * * * make it hard to draw inferences from fee levels"); *Schuyt*, 663 F. Supp. at 978 n.48 ("accounting systems are subject to significant variation in results depending on how" they "allocate common costs").[3]

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[3] Plaintiffs and *amici* admit that litigation over individual "fund profitability," a factor under *Gartenberg*, is pointless because it is based on "highly contestable facts" that are subject to "fierce dispute," making profitability "next to impossible for courts to analyze." Bogle Am. Br. 23; NASCAT Am. Br. 14; see Pet. Br. 32 n.23. The sort of arbitrary accounting allocations that make profitability analysis pointless also infect plaintiffs' proposed comparison of portfolio management fees.

C. Courts Lack The Institutional Capability To Ascertain Reasonable Mutual Fund Fees.

In light of the inherent differences between mutual funds and institutional accounts, how could a court determine what additional charge is warranted for the additional services? How, for example, would a court assign a value to investors to a fully staffed mutual fund compliance department charged with overseeing performance of myriad statutory and regulatory duties? Or to preparing, updating, and distributing a prospectus? A trial would do nothing to illuminate such metaphysical questions. Compare U.S. Am. Br. 12, 32.

With no basis to assess the "value" of services to investors, courts would necessarily resort to analysis of an adviser's costs for providing the services. That approach would run headlong into Congress's bar on "a 'cost-plus'" approach or "general concepts of rate regulation as applied to public utilities." S. Rep. No. 91-184, 1970 USCCAN at 4903; see U.S. Am. Br. 23 n.6 (conceding these methods are impermissible). Years of experience have demonstrated the deficiencies of price-setting in cost-plus regimes. And as we have explained, cost allocation is a judgment, not a science in the mutual fund industry, which would provide no objective standards for adjudication.

The comparison to fees charged to institutions advocated by plaintiffs therefore offers no solution for a court asked to second guess a board fee approval. The court would be left with the sort of amorphous "reasonableness" inquiry that Congress expressly rejected in favor of "a different method of

testing management compensation." S. Rep. No. 91-184, 1970 USCCAN at 4902.[4] Congress understood that substituting the judgment of a non-specialist court as to the appropriate level of adviser compensation for that of fund directors operating under the regulatory supervision of the SEC—based on remote comparisons and vague economic theories—would not lead to a better business judgment.

Determining what fee is proper is a role for which federal judges are institutionally unsuited. See *Pac. Bell Tel. Co.* v. *LinkLine Commc'ns*, 129 S. Ct. 1109, 1120-1121 (2009) ("Institutional concerns" require "clear rules" that courts may "adequately and reasonably supervise," not open-ended inquiries more suited to a "regulatory agency"); *Verizon Commc'ns* v. *FCC*, 535 U.S. 467, 539 (2002) (the correct rate "is the stuff of debate for economists and regulators," not judges); *Illinois Brick Co.* v. *Illinois*, 431 U.S. 720, 731, 741-43 & n.25 (1977) (refusing to take on "the uncertainties and difficulties" of applying "economic theorems" to determine whether "overcharges" occurred). As Justice Breyer has asked, "how is a judge" to "determine a 'fair price'?" and how can a "court determine this price * * * without acting

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[4] Claims of the United States (at 19) and Bogle (at 17) that the industry successfully opposed a reasonableness standard but then agreed to the same thing under the fiduciary duty standard are incorrect. The industry told Congress that "reasonableness" was unacceptable because "courts might feel called upon to substitute their business judgment for that of the directors of the fund," and that the fiduciary duty instead focused inquiry "on the substance" of the Section 15(c) process. Bogle Am. Br., App. C. Congress rejected the SEC's plea to make the standard focus on whether the fee was "unfair" when it refused to enact a reasonableness standard and included subsection (b)(2). Cf. U.S. Am. Br. 18, 19.

like a rate-setting regulatory agency, the rate-setting proceedings of which often last for several years?" *Town of Concord* v. *Boston Edison Co.*, 915 F.2d 17, 25 (1st Cir. 1990) (Breyer, C.J.)); see Rogers & Benedict, *supra*, 57 N.Y.U. L. Rev. at 1112-1114 (myriad intangible factors are considered in evaluating fees; the proper fee is "a question of business judgment not properly a subject for judicial determination").

Section 36(b) avoids these pitfalls by focusing in the first instance on the board's exercise of its business judgment in approving fees, as required by subsection (b)(2). If the court concludes that the board's decision does not warrant deference, because it was a "formality" rather than a review of "substance" (S. Rep. No. 91-184, 1970 USCCAN at 4910), it should then consider, as required by *Gartenberg* and *Jones*, whether the fee is so excessive as to amount to a breach of fiduciary duty. Only a fee so obviously excessive that a court may find a breach of fiduciary duty—without resort to the economic quibbling plaintiffs advocate—is actionable under that standard. See Pet. App. 9a; *Gartenberg*, 694 F.2d at 928.

III. PLAINTIFFS ERR IN ADVOCATING OPEN-ENDED COMMON LAW STANDARDS OR INQUIRIES APART FROM FEE LEVELS.

A. Intensive Competition, Stringent Regulation, And Extensive Disclosure Make Plaintiffs' Expansive Theory Of Liability Unnecessary To Protect Investors.

Plaintiffs contend that minute judicial dissection of fund fees and the process by which they were

approved is needed to protect investors. That argument "cannot override" the ICA's "text and structure" (*Central Bank* v. *First Interstate Bank*, 511 U.S. 164, 188 (1994)) and is "more appropriately addressed to Congress than to this Court." *Radzanower* v. *Touche Ross & Co.*, 426 U.S. 148, 156 n.12 (1976). In any event, it is erroneous because there are regulatory, judicial, and competitive constraints on fee levels that have served investors well.

Plaintiffs and their *amici* rely on statements in SEC reports and legislative history from the 1960s that competition was then lacking because fund boards were "captive" and would not switch advisers. But "a lot has happened in the last 38 years." Pet. App. 11a; see *LinkLine Commc'ns*, 129 S. Ct. at 1120 n.3 (pricing inquiry under antitrust laws controlled by *current* economic and legal conditions); *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 587-592 (1986) (determining whether pricing claim made "economic sense" by considering contemporaneous market conditions).

Regulatory action since 1972 has effectively required that at least 50% of directors be independent and has made the Section 15(c) contract review process far more robust. And the *Gartenberg* analysis has made Section 36(b) a powerful deterrent to advisers requesting excessive fees. Plaintiffs' assertion that it has been insufficiently protective of investors is contradicted by their own trial-lawyer *amici*, who concede that many Section 36(b) suits have settled with "substantial benefits" for mutual fund shareholders. NASCAT Am. Br. 9-10.

At the same time, competition in the mutual fund industry has exploded. In 2006, there were

more than 8,000 mutual funds with assets of $10,400 billion, up from 379 mutual funds with assets of $38.2 billion in 1966. Coates & Hubbard, *supra*, 33 J. Corp. L. at 157. The growth of no-load funds, fund supermarkets, and tax-advantaged investment vehicles like Section 401(k) and Section 529 plans means that switching between mutual funds today often involves no transaction costs at all.

Investors also are better informed than ever before. SEC regulations require advisers to disclose to investors information on fees, performance, risks and costs, portfolio holdings, and manager and director compensation and experience. *E.g.*, SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, ICA Release No. 28,584 (Jan. 13, 2009); SEC, *Consolidated Disclosure of Mutual Fund Expenses*, ICA Release No. 16,244 (Feb. 1, 1988). Fund investors have access to a wealth of additional information that aids in the selection of mutual fund investments. They can readily compare the costs of investing in any mutual fund, including by using simple online tools (*e.g.*, http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm) or third-party providers like Morningstar or Lipper.

A multitude of funds, transparent fee and performance data, and low transaction costs have fostered an environment in which (the SEC has admitted) "competition is fierce." SEC, *Protecting Investors*, *supra*, at 347. Advisory fees have declined dramatically in response. See 2009 Investment Company Institute Fact Book 61-63. Price wars are routine. *E.g.*, Lemann, *Schwab's Fee Cuts Challenge Vanguard, Fidelity*, Ignites, May 6, 2009 (reporting on a price war in index fund fees); *Big Fee Cuts in*

Store at Putnam, Ignites, July 28, 2009 (Putnam fee cuts "are aimed at ratcheting up competition with rivals such as Fidelity" and bring a "price war" to "active product sales"). In this environment, in which "barriers to entry" are low, it would "be impossible to maintain supracompetitive prices" for long. *Matsushita*, 475 U.S. at 591 n.15.

The "captive" label is a red herring. As explained in HERBERT HOVENKAMP, THE ANTITRUST ENTERPRISE: PRINCIPLE AND EXECUTION 205 (2005), Domino's franchisees may be "captive," and, in theory, could be forced to pay high prices to Domino's for pizza dough. But if Domino's "charge[s] its franchisees a high price for pizza dough, Domino's customers are free to purchase pizzas wherever they please. If the local Domino's franchisee overprices its pizzas," customers "will go somewhere else." Similarly, if an adviser imagined a fund was its "captive," from which supra-competitive fees could be extracted, it would quickly be reined in by an attentive board. And if the board were inattentive, it would find that its shareholders are not "captive" but, like Domino's customers, can "go somewhere else."

B. Section 36(b) Does Not Track Common Law Fiduciary Duty Standards, Which In Any Event Defer To The Business Judgment Of Boards Of Directors.

Plaintiffs' attempted reliance on common law fiduciary duties suffers from two defects: Congress did not borrow state common law duties, and common law in any event defers in analogous circumstances to the business judgment of boards of directors.

1. This Court explained in *Daily Income Fund* that Section 36(b) creates a "unique" and "entirely new right" that "differs significantly" from pre-existing state law rights. 464 U.S. at 534 n.10, 535, 541. That provision, as the SEC informed this Court in *Burks*, establishes "federal standards," and in interpreting those standards it is "the policies of federal law" that "are significant." 1978 WL 207114, at *11, *16 n.12; see *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 744-745 (1975) (common law rules were developed in a world "light years away from the world of commercial transactions to which" federal securities laws apply).

The meaning of "fiduciary duty" in Section 36(b) must be interpreted in the context of the overall statutory scheme of the ICA. The federal policies of the ICA that we have described—a rigorous Section 15(c) contract review process, director independence, deference to directors who engage in substantive consideration of fees, rejection of "reasonableness" and rate-regulatory standards, and focus on whether compensation was blatantly excessive given all services provided—show that Section 36(b) "was intended to provide a very specific, narrow federal remedy that is more limited than * * * common law doctrines." *Green*, 286 F.3d at 685; accord *Green* v. *Nuveen Advisory Corp.*, 295 F.3d 738, 743 (7th Cir. 2002) (same); see also *Central Bank*, 511 U.S. at 184 (though securities laws are "deeply rooted" in common law, "it does not follow that Congress intended to apply that kind of liability to the private causes of action in the securities Acts").

Additional federal policies that have guided this Court's interpretation of the securities laws (discussed in Parts II and IV), include preferring clear

liability rules over hazy ones; avoiding interpretations that encourage vexatious litigation, make it difficult to dispose of baseless suits on pre-trial motions, or lead to blackmail settlements; and avoiding interpretations that would take courts beyond their institutional abilities. All those policies point toward a circumscribed cause of action under Section 36(b).

The label "fiduciary," this Court has explained, "only begins analysis." *SEC* v. *Chenery Corp.*, 318 U.S. 80, 85-86 (1943). Because Congress intended "federal courts to interpret" Section 36(b)'s "'fiduciary duty' in the ['federal common law'] tradition" (*Gartenberg*, 528 F. Supp. at 1046), and because federal policies weigh heavily against an expansive interpretation, the open-ended state common law doctrines plaintiffs rely upon are irrelevant.

2. Insofar as state common law principles have any import, it is those principles that concern "the traditional function of the courts to enforce such fiduciary duties in *similar type relationships*." S. Rep. No. 91-184, 1970 USCCAN at 4902. One critical feature of the relationship here is that an adviser's compensation must be approved by a largely independent fund board and is reviewed annually in a process closely guided by Section 15(c), SEC regulation, and judicial precedent. Another is that investors who believe fees are too high have an exit option —a dissatisfied shareholder can easily move her money to another fund or different investment entirely. The general principles of trust and agency law which plaintiffs cite are far removed from this special context.

Congress in the ICA recognized the special relevance of board approval, enacting Section

36(b)(2) and explaining that the statute embraced "concepts developed by the courts as to the authority and responsibility of directors." S. Rep. No. 91-184, 1970 USCCAN at 4903. Rejecting the most stringent common law "waste" standard for review of director action, Congress directed courts to inquire instead whether the board engaged in substantive review under Section 15(c). Plaintiffs supply no plausible reason why this Court should borrow common law fiduciary standards used in far less analogous circumstances—standards that in any event, as *amicus* SIFMA explains (at 16-24), would not override agreed-upon, market-level fees.

C. Adviser Conduct Does Not Provide A Basis For A Section 36(b) Suit Separate From The Fee Level.

Plaintiffs advocate an alternative theory of Section 36(b) liability adopted by the Eighth Circuit in *Gallus* v. *Ameriprise Financial, Inc.*, 561 F.3d 816 (8th Cir. 2009). There, the court concluded that Section 36(b) "looks to both the adviser's conduct during negotiation and the end result" and that "[u]nscrupulous behavior with respect to either can constitute a breach of fiduciary duty." *Id.* at 823. It suggested that adviser conduct during the board's review process may violate Section 36(b) even though the fee "passed muster under the *Gartenberg* standard." *Ibid.* And it held that a dispute between experts about whether the adviser "purposefully omitted, disguised, or obfuscated information that it presented to the Board about the fee discrepancy between different types of clients" raised a question of material fact precluding summary judgment. *Id.* at 824.

That ruling is inconsistent with the statute. Under Section 36(b)(2), mere disagreement with the amount or type of information the adviser supplied or the weight the board gave information does not create an issue of fact that invites a court to second guess the board's business judgment. See Part II, *supra*. Alleged deficiencies in the Section 15(c) process must be so fundamental that they preclude the board from making a "responsible determination." S. Rep. No. 91-184, 1970 USCCAN at 4903. And even when that showing can be made, it is not an independent basis for liability. It simply overcomes deference to the business judgment of the board and focuses the inquiry instead on whether the fee is so disproportionate to services provided as to be obviously improper.[5]

Gallus's open-ended deception theory is unlike any express securities liability Congress ever created. Actions for misrepresentation or omission are all carefully circumscribed by Congress and by the courts. See, *e.g.*, *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 201 (1976); *Blue Chip Stamps*, 421 U.S. at 754-755; *Stoneridge Inv. Partners, LLC* v. *Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 774 (2008). In the

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[5] In *Gallus* the board obtained a report from the adviser showing that the services provided "were different than those provided to the institutional clients." 497 F. Supp. 2d 974, 982 (D. Minn. 2007). The board's consideration of that data and the fact that the agreed-upon fee was within normal limits refuted plaintiffs' claim that substantive review had not occurred. *Id.* at 983. And plaintiffs failed to link "alleged deficiencies" to "the results of the Board's fee-negotiation process." *Ibid.* That is the classic situation in which a court should defer to the business judgment of the board. It is legally irrelevant that plaintiffs can find an expert to say that the data should have been presented differently.

securities registration context, there are schedules of information that must be disclosed, and omission of information not expressly required to be disclosed is actionable only if it makes an affirmative statement misleading. In the proxy context, there are again specific required disclosures. Periodic corporate reports are governed by disclosure schedules and rules. The ICA and SEC regulations prescribe specific disclosure requirements that the Commission enforces under Sections 15(c) or 36(a). By contrast, *Gallus* would open up a new disclosure-based cause of action under a provision that contains no rules of disclosure or misrepresentation at all. This Court should reject plaintiffs' invitation to invent a new theory of liability that bears no resemblance to any disclosure-based cause of action prescribed by Congress and that has no basis in the language of the statute.

IV. STANDARDS THAT PERMIT PRE-TRIAL DISPOSITION OF WEAK SECTION 36(b) SUITS AVOID WASTE OF JUDICIAL AND SHAREHOLDER RESOURCES.

Plaintiffs advocate a broad liability rule with no support in the statutory text, structure, or history, or relevant common law. The rule they advocate also is unnecessary given competition among funds and the SEC's comprehensive authority over the Section 15(c) process whereby fund trustees "request and evaluate," and investment advisers "furnish," information reasonably "necessary to evaluate" the fee. Plaintiffs' approach would burden courts with open-ended factual and economic inquiries that cannot efficiently be managed by courts. It threatens massive discovery and decade-long litigation (or forced settlements) for every adviser with respect to

every fund, because it lacks standards to identify weak claims and dispose of them early. Specific standards set forth in the statute, however, promote efficient pre-trial disposition.

A. Properly Analyzed, Section 36(b) Standards Promote Pre-Trial Disposition Of Weak Claims.

According to plaintiffs, allegations that an adviser charged fund investors higher fees than those paid by institutional investors would be enough to survive dismissal, and the comparability of those fees would be the subject of conflicting expert testimony that prevents summary judgment. Pet. Br. 50 n.50; see also U.S. Am. Br. 32. Plaintiffs envisage too that alleging that an adviser should have provided more or different information to fund trustees and hiring an expert to so opine would be enough to get to trial, regardless of the amount of the fee. Pet. Br. 33; see also Law Prof. Am. Br. 30-31; NASCAT Am. Br. 16-17. Experts for plaintiffs in Section 36(b) suits have testified that they believe most fund complexes charge excessive fees. See *Goetz* v. *Crosson*, 967 F.2d 29, 37 (2d Cir. 1992) (van Graafeiland, J., concurring in part) ("an 'expert' can be found to support almost any position if one searches long enough and pays well enough"). Under plaintiffs' approach, every claim will evade pre-trial disposition.

Such open-ended liability standards guarantee that private Section 36(b) suits will be "employed abusively to impose substantial costs on [those] whose conduct conforms to the law." *Tellabs, Inc.* v. *Makor Issues & Rights*, 551 U.S. 308, 313 (2007). As the Solicitor General recently reminded this Court when advocating a "standard [that] reflects the

critical importance of the pleading stage in private securities litigation," lax rules encourage "'nuisance filings'" and "'vexatious discovery requests,'" which in turn lead to "'extortionate settlements.'" U.S. Am. Br. in *Tellabs*, *supra*, No. 06-484, at 21 (quoting *Merrill Lynch* v. *Dabit*, 547 U.S. 71, 81 (2006)).

Those detrimental consequences are just as substantial in Section 36(b) litigation, in which discovery targets both advisers and fund boards of directors and, combined with the annual second-guessing of director conduct that plaintiffs propose, would "dete[r] qualified individuals from serving on boards." *Dabit*, 547 U.S. at 81; see *Blue Chip Stamps*, 421 U.S. at 741 (describing the asymmetrical burden of "extensive deposition of the defendant's officers and associates and the concomitant opportunity for extensive discovery of business documents"); Easterbrook, *Discovery as Abuse*, 69 B.U. L. Rev. 635, 643-645 (1989). The large amounts at stake in fee suits mean that a case not disposed of before trial may never reach an adjudication on the merits. See *Blue Chip Stamps*, 421 U.S. at 740 (a weak complaint "has a settlement value * * * out of any proportion to its prospect of success at trial so long as [plaintiff] may prevent the suit from being resolved against him by dismissal or summary judgment").

If trial does occur, plaintiffs here insist that courts must adjudicate fees based on a judge's assignment of "value," an untethered inquiry that would turn mutual funds into a judicially rate-regulated industry, subvert competition, and "ultimately result in more harm than good." *Hochfelder*, 425 U.S. at 214 n.33. The threat of judicially imposed retroactive fee reductions

following each renewal of a management agreement would make conducting an adviser's business a matter of guesswork. See *Dabit*, 547 U.S. at 80 ("the very pendency of the lawsuit may frustrate or delay normal business activity"). As the Court has observed, "[t]he hazards of a business conducted on these terms are so extreme as to enkindle doubt whether a flaw may not exist in the implication of a duty that exposes to these consequences." *Blue Chip Stamps*, 421 U.S. at 748 (quoting *Ultramares Corp.* v. *Touche, Niven & Co.*, 255 N.Y. 170, 179-180 (1931) (Cardozo, C.J.)); accord *Dirks* v. *SEC*, 463 U.S. 646, 658 n.17 (1983).

By advocating liability rules that rest on speculative and endlessly contestable economic theories, plaintiffs and the SEC contradict this Court's preference for standards that permit courts to dispose of unmeritorious actions early in the litigation. *E.g.*, *Bell Atl. Corp.* v. *Twombly*, 550 U.S. 544, 558-559 (2007) (deficiencies should "'be exposed at the point of minimum expenditure of time and money by the parties and the court'" or "discovery expense will push cost-conscious defendants to settle even anemic cases"); *Celotex Corp.* v. *Catrett*, 477 U.S. 317, 327 (1986) (summary judgment is not "a disfavored procedural shortcut," but "an integral part of the Federal Rules"). "[P]rocedural intractibility" would make Section 36(b) actions especially burdensome because the "issues would be hazy," the "litigation protracted," and the "resolution unreliable." *In re Merrill Lynch & Co.*, 273 F. Supp. 2d 351, 366 n.28 (S.D.N.Y. 2003) (Pollack, J.) (quoting *Grace* v. *Rosenstock*, 228 F.3d 40, 48 (2d Cir. 2000)).

As this Court has observed of related statutes, extending the Section 36(b) cause of action "makes

the civil remedy more far reaching, but it does not follow that the objectives of the statute are better served." *Central Bank*, 511 U.S. at 188. As we have explained in Part I, the objective of Section 36(b) is clear on the face of the statute—to provide a remedy for fees so excessive that they evidence a breakdown in the Section 15(c) process, while deferring to the business judgment of a fund board that has substantively reviewed and approved the adviser's fee. These standards are procedurally manageable, as litigation since *Gartenberg* demonstrates. *E.g.*, *Amron* v. *Morgan Stanley Inv. Advisors, Inc.*, 464 F.3d 338, 344-346 (2d Cir. 2006) (dismissal); *Green* v. *Nuveen Advisory Corp.*, 295 F.3d 738 (7th Cir. 2002) (summary judgment).

Proper application of these standards curtails the coercive potential of fee actions and makes meritless claims easier "'to dispose of before trial'" (*Blue Chip Stamps*, 421 U.S. at 742-743), fulfilling Congress's purpose "to eliminate nuisance suits." H.R. Rep. No. 91-1382, at 38 (1970). To state a claim a plaintiff would have to plead "sufficient factual matter"—not "'labels,'" "'conclusions,'" or "'naked assertions'"—to show that there are special "circumstances" that make it not "appropriate" to defer to the fund board's business judgment approving the fee. *Ashcroft* v. *Iqbal*, 129 S. Ct. 1937, 1949 (2009); ICA § 36(b)(2).

Such allegations might include facts showing that trustees rubber-stamped the fee without undertaking substantive review, that the dialogue between the adviser and fund board contemplated by Section 15(c) did not occur, or that there were other deficiencies in the review process so fundamental that they precluded the board from making a business judgment. Allegations showing that the fee

is higher than that charged by advisers to comparable funds should not be sufficient to overcome deference to the board's judgment absent other allegations permitting the court to infer that the board did not give substantive consideration to the amount of the fee in the context of services provided. See *Iqbal*, 129 S. Ct. at 1949, 1951 (not enough to plead facts "that are 'merely consistent with' a defendant's liability"; to "plausibly establish" liability, complaint must eliminate "'obvious alternative explanation[s]'"). The higher a fee compared to others in the relevant market, the easier it may be for a plaintiff to plead other facts showing that deference is unwarranted. See Pet. App. 9a.

Allegations that directors, who gave substantive consideration to the level of management fees, might have requested or the adviser might have supplied different information are not sufficient to plead that deference is unwarranted. Nor is any other process-focused allegation sufficient when reasonable people could differ about the relevance or meaning of the supposed defect. It is not enough for plaintiffs simply to allege that institutional investors paid less, when the fund board considered that fact in its deliberations. If such allegations—which could be made against virtually every fund—stated the plausible claim for relief necessary to survive a motion to dismiss, this would make a mockery of Section 36(b)(2) and of Congress's intent not to "authorize a Court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees." S. Rep. No. 91-184, 1970 USCCAN at 4902-4903.

When pleadings are sufficient to undermine the substantial deference due to the board, the focus of

the dismissal inquiry should move to the amount of the fee itself. To survive dismissal plaintiffs must adequately plead that the fee was "so disproportionate" to services provided or "so unusual" as to show that the agreement could not have been the product of arm's-length bargaining. That inquiry is "context-specific" and requires a court "to draw on its judicial experience and common sense." *Iqbal*, 129 S. Ct. at 1950. But because "some inference" of misconduct is not enough, *id.* at 1952, a pleading would have to allege that the fee was significantly higher than that paid by comparable funds *and* plead facts showing the higher fee was not justified by services provided. A plaintiff could not meet that burden without also pleading facts showing that competition—which drives investors to funds with reasonable fees—failed in the particular market.

Unlike plaintiffs' proposal, this inquiry achieves what Congress intended by giving deference to the actions of fund directors in reviewing fee agreements, while protecting investors from excessive fees in extraordinary cases.

B. Applying The Correct Standards, The Judgments Below Should Be Affirmed.

Just as a plaintiff must allege such facts to survive dismissal, he must produce substantial evidence to support them to avoid summary judgment. Here, plaintiffs failed to do so. See *Matsushita*, 475 U.S. at 586-588 (summary judgment

appropriate in complex case involving economic debate over proper price levels).[6]

As Judge Kocoras held in granting summary judgment under the traditional *Gartenberg* standard, the Oakmark funds' independent trustees attended to their duty of considering Harris's management contract, and Harris complied with its Section 15(c) obligation to provide the trustees with the information necessary for review, including "fees charged to Harris's other clients." Pet. App. 16a. The court also found no evidence that the trustees were not disinterested, as plaintiffs alleged. *Id.* at 24a-26a, 30a-31a. The fee was comparable to those charged to similar funds, well within the acceptable range, and certainly not indicative "that self-dealing was afoot." *Id.* at 30a. And the "services Harris provided to institutional clients" were "more limited than those they provided to the Funds." *Id.* at 16a. Accordingly, plaintiffs produced no evidence showing that it was inappropriate to defer to the Oakmark funds' board's approval of Harris's fee. Given that record—and the outstanding performance of these funds—plaintiffs' "elaborate story of what they believe should have transpired between the Funds and Harris in order to produce a deal that would ultimately be more advantageous to the Plaintiffs" was "irrelevant." *Id.* at 32a. This record gives no reason to second guess the board's business judgment, and provides a sound

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[6] This Court can affirm on any ground that the law and record supports. *E.g.*, *Brooke Group* v. *Brown & Williamson Tobacco Corp.*, 509 U.S. 209, 232-243 (1993); *Stoneridge*, 128 S. Ct. at 769. This Court's application of the correct legal standards to this record would serve important educational purposes for the industry and lower courts.

basis for the Seventh Circuit's ruling (see *id.* at 8a), which should be affirmed.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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SEPTEMBER 2009

AMICUS CURIAE BRIEF

Supreme Court, U.S.
FILED
SEP 3 - 2009
OFFICE OF THE CLERK

(18)

No. 08-586

IN THE

Supreme Court of the United States

JERRY N. JONES, et al.,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Seventh Circuit

BRIEF FOR INDEPENDENT DIRECTORS COUNCIL AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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QUESTION ADDRESSED BY AMICUS

Congress has directed the independent directors of mutual funds to annually evaluate and approve the fund's advisory contract, including fees. Congress has further directed that such director approval must be given appropriate weight in any lawsuit challenging advisory fees. Does the standard proposed by petitioners in this case—under which courts would scrutinize advisory fees *de novo*, without deference to prior director approval—conflict with these congressional directives?

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INTEREST OF *AMICUS CURIAE*[1]

The Independent Directors Council (IDC) serves the mutual fund independent director community and provides a venue to advance the education, communication, and policy positions of mutual fund independent directors so as to promote the highest standards of fund governance. IDC and its predecessor have successfully worked to achieve these goals for over a decade.

The activities of IDC are led by a Governing Council of independent directors from among the 2,000 directors who sit on the boards of the Investment Company Institute (ICI) member funds. As of 2008, ICI's members collectively managed 98 percent of the approximately $10 trillion in U.S. mutual fund assets on behalf of more than 90 million investors in over 50 million households. While IDC is part of ICI, IDC has its own leadership, committees, and dedicated staff, and provides the perspective of fund independent directors on policy matters.

In light of the broad and diverse views of the independent directors it serves, IDC is uniquely positioned to speak to the significant role that independent directors play in evaluating and approving fund

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief are on file or have been submitted to the Clerk. Pursuant to this Court's Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amicus* or its counsel made a monetary contribution intended to fund the preparation or submission of this brief. Two members of IDC's Governing Council, Gary N. Wilner and Laura T. Starks, have previous connections to respondent or this litigation. Out of an abundance of caution, these members did not participate in the preparation or approval of this brief for filing.

advisory fees, and the rigorous nature of that business decision. IDC believes that its brief will also assist the Court in understanding the larger practical and policy reasons why investors—the protection of whom is both an overriding goal of the securities laws and the key responsibility of independent directors—would be best served by judicial deference to the business judgment of the independent directors absent proof that the directors' approval was a mere formality, or that there were other deficiencies in the approval process so fundamental that they precluded the board from exercising its business judgment.

SUMMARY OF ARGUMENT

I. Petitioners (and many of their *amici*) have put forth a distorted caricature of the role played by independent directors in fund governance, particularly with respect to the review and approval of advisory fees. Petitioners portray independent directors as mere puppets of the adviser, powerless to participate in a meaningful dialogue regarding fees and related matters, such as fund performance.

This depiction has no basis in reality. On the contrary, the dictates of the Investment Company Act, as amended, coupled with innovation within the industry, have ensured that modern-day fund boards are robustly independent. In fact, the vast majority of fund boards have at least 75 percent independent directors, and an independent chair or independent lead director. And, as the Securities and Exchange Commission (SEC) has repeatedly recognized either expressly or through its increased reliance on fund boards in its regulatory actions, the enhanced independence of board members, together with their conscientiousness and expertise, have successfully protected investor interests.

II. Against this backdrop, the non-existent role that petitioners and their *amici* (with the notable exception of the United States) envision for a board's business judgment cannot be squared with the statutory regime, this Court's decisions, or practical and policy considerations.

Unlike petitioners' "statutory" analysis, which does not even mention Section 36(b)(2) of the Act (*see* Pet. Br. 20-34), this Court must construe all components of Section 36(b). This requires, at minimum, "appropriate" deference to the directors' approval, as warranted under "the circumstances." 15 U.S.C. § 80a-35(b)(2). To give effect to this statutory directive, a court must defer to the independent directors' exercise of their business judgment in approving the advisory fees. In contrast, little or no deference may be due when the directors' approval was a mere formality, or when there were other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment. If (but only if) such fundamental deficiencies are proved, courts may review advisory fees *de novo*, utilizing factors such as those articulated in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982).

This construction of Section 36(b)(2), unlike petitioners', fully accords with Section 15(c) of the same Act, which entrusts independent directors with the primary responsibility for reviewing and approving advisory contracts, including fees. 15 U.S.C. § 80a-15(c). This statutory structure establishes that while Congress did not envision a system in which independent directors would need to approve the decision to initiate Section 36(b) suits (*Daily Income Fund* v. *Fox*, 464 U.S. 523, 540 (1984)), Congress relied principally, albeit not solely, on independent directors to

protect investors against excessive fees, and tasked courts with deferring to the directors' business judgment absent fundamental deficiencies in the approval process. As this Court has noted, "it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that," require that their role be completely or significantly ignored. *Burks* v. *Lasker*, 441 U.S. 471, 484-85 (1979).

The practical and policy considerations for departing from this congressionally mandated deference lack merit. In requiring business decisions to be made in the first instance by non-specialist courts, the non-deferential standard proposed by petitioners would disserve investors. Moreover, its inevitable outcome—permitting a trial in every case—is not an unmitigated good. Extensive litigation over mutual fund fees would only serve to increase those fees, as the costs of litigation will be borne by the very investors on whose behalf it is ostensibly brought. Extensive litigation would also deter highly qualified individuals from serving as independent directors, undermining the governance scheme established by Congress and ultimately harming investors.

ARGUMENT

Congress entrusted independent directors, not courts or litigants, with the "primary responsibility" for protecting investor interests. *Burks* v. *Lasker*, 441 U.S. 471, 484-85 (1979). Modern-day fund boards have scrupulously performed that job, including in matters of advisory fees. There is no reason therefore for this Court to depart from the standard of judicial review of advisory fees set out by Congress, in which the independent directors' approval

receives its due, "appropriate" deference. 15 U.S.C. § 80a-35(b)(2).

I. Independent Directors Bear Primary Responsibility For Protecting Investors

Registered investment companies—which consist predominantly of "mutual funds"—are subject to a comprehensive and reticulated set of federal and state requirements.[2] Each mutual fund may be established as either a corporation or a business trust (or a series of such a corporation or trust) under state corporate law, and must be registered with the SEC pursuant to the Investment Company Act of 1940. In offering shares to the public, mutual funds and their affiliates must also comply with the Securities Act of 1933 and the Securities Exchange Act of 1934, and each adviser to the mutual fund must comply with the Investment Advisers Act of 1940. Each mutual fund is governed by a board of directors (if a corporation) or trustees (if a trust), again subject to state corporate law. The ICA defines "director" to include trustees. 15 U.S.C. § 80a-2(a)(12).

Modern-day fund directors are also subject to more federal obligations and requirements than any other corporate directors, to the benefit of fund shareholders. And owing to their independence, expertise, and fiduciary duties requiring them to be diligent and informed, fund directors vigorously promote and protect investor interests. The evaluation and approval of advisory fees make no exception.

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[2] U.S. investment companies include open-end funds, closed-end funds, exchange-traded funds, and unit investment trusts. For ease of reference, the term "mutual fund" is here used to refer to registered investment companies governed by a board of directors or trustees that is subject to the Act.

A. Independent Directors Rigorously Review The Fund's Advisory Agreement Each Year

1. A central, if largely unstated, premise of the arguments advanced by petitioners and most of their *amici* is that mutual fund directors are unwilling or unable to protect the interests of investors, warranting judicial intervention in virtually every instance. In petitioners' retelling, fund directors are mere puppets of the adviser who rubber-stamp the advisory fee and other aspects of the contractual relationship between the adviser and fund. Pet. Br. 5 n.3, 36. Only by so denigrating the directors and their role can petitioners and their *amici* contend that courts should give little or no deference to director decisionmaking in a lawsuit brought under Section 36(b) of the 1940 Act.

This premise of petitioners' argument, however, is false. While petitioners repeatedly cite the 1962 "Wharton Report" (10 times) and the 1966 "SEC Report" (11 times), the world has not stood still for the past half century. Although more lenient standards for fund governance and director "independence" existed when those reports issued, Congress addressed those issues in the 1970 Amendments to the Investment Company Act. Those Amendments substantially strengthened the independence standards by adding several categories of persons who could no longer be considered independent, such as "any member of the immediate family" of any natural person who is an officer, director, partner, copartner, or employee of the adviser. Investment Company Act Amendments of 1970, P.L. 91-547, 84 Stat. 1416, Sec. 2(a) (1970); *see also* 15 U.S.C. § 2(a)(19)(B); 15 U.S.C. § 2(a)(3). In addition to these statutory changes, enhanced regulatory safeguards and voluntary compli-

ance with industry best practices have also helped strengthen fund governance. Indeed, in the aftermath of the 1970 Amendments to the ICA, fund governance standards have consistently surpassed general corporate governance standards.

As a result, far from being captive to advisers, modern-day fund boards are robustly independent. For example, while the Act requires that at least 40 percent of directors be independent of the adviser, in practice, independent directors hold an overwhelming majority (75 percent) of board seats in nearly 90 percent of fund complexes participating in the ICI/IDC Directors Practices Study. *See* Overview of Fund Governance Practices, 1994-2006, http://www.ici.org/pdf/rpt_07_fund_gov_practices.pdf ("Overview of Fund Governance Practices"). Contrary to some uninformed suggestions, directors generally set their own compensation, and 97 percent of independent directors have never been employed by the fund complex. *Ibid.* And more than 75 percent of fund complexes have boards that are led by an independent chair or independent lead director. *Ibid.*

Moreover, as required by SEC regulations, it is independent directors, not advisers, who are tasked with selecting and nominating other independent directors. 17 C.F.R. § 270.0-1(a)(7). The SEC's regulations also generally require that any legal counsel for independent directors be "independent legal counsel," that boards conduct annual self-assessments designed to increase their effectiveness, and that independent directors meet in executive session at least quarterly. *Ibid.* (While the SEC mandated these requirements only as a condition of reliance on certain exemptive rules, substantially all funds rely on one or more of these rules, and thus the requirements apply to virtually all funds.)

The effectiveness of fund directors is a product not only of their independence from the adviser, but also of the in-depth knowledge they develop through their sustained and ongoing oversight of numerous aspects of fund operation and management. In addition to reviewing and approving advisory fees and overseeing the performance of the fund, fund boards are also tasked with, among others, approving the auditor and principal underwriter for the fund and making fair value determinations for certain securities held by the fund. SEC rules further require boards to oversee a variety of transactions involving potential conflicts of interest between the fund and its investment adviser or the adviser's affiliates (*e.g.*, transactions involving purchases of securities from or through an affiliate, participation in a joint insurance policy, purchases of a fidelity bond, mergers with an affiliated fund, or usage of fund assets to finance distribution). Boards also oversee the audit and compliance functions, and must approve written compliance policies and procedures designed to prevent violations of federal securities laws. Investment Company Act Release No. 26299 (Dec. 17, 2003). To assist independent directors in performing their responsibilities, the SEC requires a mutual fund's chief compliance officer to report directly to the board of directors. *Ibid.* Boards also must approve the hiring and compensation, and if necessary, firing, of the chief compliance officer. *Ibid.* To facilitate frank discussions, the chief compliance officer is required to meet separately with the independent directors, in addition to submitting an annual written report to the full board. *Ibid.*

These myriad responsibilities required by federal law are discharged within the framework of fiduciary duties established for directors under state corporate

law. As a result of changes in the business judgment rule in the past three decades, directors of funds and corporations alike must perform all their duties in "an informed and deliberate manner." *Smith* v. *Van Gorkom*, 488 A.2d 858, 873 (Del. 1985). Therefore, in order to reach informed decisions, directors devote substantial time and consider large amounts of information related to various aspects of fund operation and management. This, in turn, provides fund directors with the experience and depth of understanding that ultimately allow them to take quick, effective, and flexible action when issues arise.

One of the independent directors' most important responsibilities is to annually evaluate and approve the advisory contract, including the amount of compensation provided to the adviser. The Act requires that a majority of a fund's independent directors annually approve the fund's advisory contract at an in-person meeting called for that purpose. 15 U.S.C. § 80a-15(c). As explained below, the SEC has by regulation further specified the factors that independent directors are to consider during their evaluation.

2. From reading petitioners' brief, the Court might be left with the impression that the independent directors' annual approval of the advisory fee is nothing more than a foregone conclusion, to be afforded little or no consideration in the context of a Section 36(b) lawsuit challenging that very fee. The truth is otherwise. The annual contract approval process involves substantial time commitment and deliberations, and careful consideration of significant amounts of information.

While the statute requires one annual in-person meeting of the independent directors for the purpose

of evaluating and approving the advisory contract, the process of preparing for that meeting takes several months, and often the entire year. Independent directors spend a significant amount of time preparing for, and participating in, numerous other meetings at which they develop questions for the adviser probing the appropriateness of the fee (with particular emphasis on the factors discussed in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982)), review the answers provided by the adviser, and solicit additional information when the information provided by the adviser is deemed insufficient. In the process, independent directors consider and review hundreds if not thousands of pages of detailed information, some of which is provided by third-party consultants. Should they feel that additional assistance is warranted, directors are free to engage independent legal counsel—and most do so. *See* Overview of Fund Governance Practices at 15-16.

In addition to preparing for and participating in meetings or other board activities that specifically address fee approval, directors spend a significant amount of time throughout the year in performing other duties that inform the fee-approval process. For example, in discharging their obligations to monitor fund performance and oversee the compliance function, directors constantly assess the quality of the services provided by the adviser. Should any of those services need improvement, directors can and do require advisers to provide appropriate additional resources to resolve the issue.

Under Section 15(c) of the ICA, the board must "request and evaluate," and the adviser must furnish, "such information as may reasonably be necessary" for the board "to evaluate the terms" of advi-

sory contracts. 15 U.S.C. § 80a-15(c). Through a disclosure rule, the SEC has required boards to consider "(1) [t]he nature, extent, and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates . . . ; (4) the extent to which economies of scale would be realized as the fund grows; and (5) whether fee levels reflect these economies of scale for the benefit of fund investors." Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, 69 Fed. Reg. 39,798, 39,801 (June 30, 2004). These five factors, as the SEC acknowledges, mirror those articulated in *Gartenberg*. *Id.* at 39,801 n.31.

Consideration of each of these factors involves a multi-faceted analysis of several other sub-factors. For example, in evaluating the quality of the services provided by the adviser, boards analyze multiple services, such as investment management, valuation, and compliance. As to compliance alone, boards would typically consider information not only on the adviser's compliance structure, but also on the results of any regulatory, third-party, or self-audits of the adviser, any deficiencies found, and any corrective actions.

The *Gartenberg* factors, as implemented through the SEC's disclosure rule, thus set a floor, not a ceiling, on the type of information boards request from the adviser. And, in light of the breadth of information relevant to each of the factors, they easily encompass most, if not all, other information that can be relevant to analyzing advisory fees. For example, although not a standalone factor, the fees, services, and performance of other mutual fund advisers can

help situate within context the services and performance of the adviser (the first two factors enunciated by the SEC). The SEC requires disclosure of the board's reliance on any such comparison, or on comparisons with the fees and services the adviser provides to "pension funds and other institutional investors." 69 Fed. Reg. 39,801-02. As discussed more fully below, because the portfolio management services provided to retail and institutional investors are typically not comparable, the latter comparison is rarely relevant.

The independent directors' expertise and in-depth knowledge of the funds they oversee also render them uniquely qualified to determine which factors should receive a lesser or greater weight in the evaluation process, in light of the specific circumstances faced by each fund in a particular year or in past years. For example, with respect to fund complexes that include several related funds, individual-fund cost allocations and profitability analyses are generally less helpful than an aggregate cost or profitability analysis, and may receive less weight than other factors. Indeed, petitioners appear to recognize as much. *See* Pet. Br. 32 n.23.

Finally, compliance with the SEC's extant regulations necessitates a rigorous review of the *Gartenberg* factors. The SEC requires that the basis of the board's approval decision be disclosed to shareholders in reports and proxy statements, discussing with specificity the five factors; these reports are filed with the SEC. Under the regulations, mere "conclusory statements or a list of factors will not be considered sufficient disclosure, and . . . a fund's discussion must relate the factors to the specific circumstances of the fund and the investment advisory contract." 69 Fed. Reg. 39,802. That is, the disclosure must

"state how the board evaluated each factor." *Ibid.* For example, it is not sufficient to state that the board considered a factor without "stating *what* the board concluded" about that factor and "*how* that affected its determination that the contract should be approved." *Ibid.* (emphases added).

It also bears noting that, in order to facilitate SEC examiners' "review of whether directors are obtaining the necessary information to make an informed assessment of the advisory contract," the SEC has required "that funds retain copies of the written materials that directors considered in approving an advisory contract." 69 Fed. Reg. 39,799. These documentation requirements make it exceedingly difficult for directors to engage in a perfunctory approval. *Cf. Wolff* v. *McDonnell*, 418 U.S. 539, 565 (1974) ("the provision for a written record helps to insure that administrators, faced with possible scrutiny by [regulators]. . . will act fairly").

3. The SEC regularly examines fund boards' discharge of their statutory obligations, including the approval of advisory fees. In summarizing the results of its examinations, the SEC has concluded that "*most* boards of directors *are* obtaining the necessary information to evaluate the various types of fund fees and expenses, as well as costs not reflected in a fund's expense ratio." Memorandum from Paul F. Roye, Director of the SEC's Division of Investment Management, to Chairman William H. Donaldson, regarding correspondence from Chairman Richard H. Baker, House Subcomm. on Capital Markets, Insurance and Government Sponsored Enterprises (June 9, 2003) ("SEC Response"), at 49 (emphases added). And in a 2000 report on advisory fees, the SEC's Division of Investment Management concluded that "the current statutory framework's primary reliance

on disclosure and procedural safeguards to determine mutual fund fees" is "sound and operates in the manner contemplated by Congress." SEC Div. of Inv. Mgmt., Report on Mutual Fund Fees and Expenses (Dec. 2000) ("SEC Fee Study"), http://www.sec.gov/news/studies/feestudy.htm. That fund directors are trusted to perform a conscientious job is also evidenced by the SEC's increased reliance on fund boards to safeguard investor interests in its regulatory actions.[3]

Against this backdrop, the reliance by petitioners and their *amici* on pre-1970 studies to criticize the independence and effectiveness of fund boards is unwarranted. Rather, as the SEC has observed, the post-1970 changes "have led to stronger, more independent, fund boards, which are today better equipped to deal with conflicts that arise in the management of funds, including the oversight of fund expenses." SEC Response at 49. Petitioners offer nothing credible to the contrary.

B. Independent Directors Have Successfully Safeguarded Investor Interests

Petitioners have chosen to ignore the way independent directors function in the real world, including the SEC's extensive regulation of the contract-

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[3] *See, e.g.*, Mutual Fund Redemption Fees, 70 Fed. Reg. 13,328, 13,330 (Mar. 18, 2005) (relying on directors to determine the propriety of a redemption fee and noting that directors "are better positioned to determine whether the fund needs a redemption fee and, if so, [its] amount"); Paul S. Atkins, Commissioner, SEC, Remarks Before the Independent Directors Council (Nov. 28, 2007) ("independent directors' list of duties is longer than ever as the SEC relies more heavily on them than ever before").

approval process. Instead, according to petitioners, the statutorily mandated annual approval should be disregarded on the sole basis that boards cannot engage in "arm's-length bargaining" because they supposedly lack the power to replace advisers. Pet. Br. 5 & n.3. The only support provided for this key assertion consists of two reports that, among many other faults, should be suspect for no reason other than the fact that they are almost *five decades old*.[4] But, as discussed above, the magnitude of changes wrought by the 1970 Amendments and all the other subsequent changes to fund governance cannot be denied. As a result of these changes, modern-day boards are sufficiently independent to have the power to replace advisers, as appropriate.

Indeed, as the SEC itself has explained, "[t]he infrequency with which fund directors have rejected investment advisory contracts does not necessarily indicate that [directors] . . . have not been forceful enough in representing shareholders' interests." SEC Response at 60. This is because "directors can and frequently do employ means other than contract termination to effect changes in the best interests of funds." *Ibid.* For example, directors can require the investment adviser to increase the quality of its services or take appropriate steps to improve its performance, such as by:

- hiring a new portfolio manager for the fund;

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[4] *See* Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337 (1966) ("SEC Report"); A Study of Mutual Funds Prepared for the Securities and Exchange Commission by the Wharton School of Finance and Commerce, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 4 (1962).

- moving to a team approach of portfolio management;
- increasing the adviser's investment research capability;
- insisting on retention of a sub-adviser; or
- merging or liquidating the fund.

Ibid.

That directors employ a gradated approach under which they seek a variety of improvements from advisers before considering whether to replace the advisers is entirely consistent with—in fact, required by—their responsibilities to their funds. Because replacing the investment advisers would replace the fund's entire operational personnel, such changes are recognized as costly, disruptive, and thus imprudent unless employed as a measure of last resort. *See, e.g.*, SEC Report at 127 (noting "[t]he possibility of disrupting the fund's operations, the prospect of a bitter and expensive proxy contest and the risk and uncertainty of replacing an entire fund management organization with a new and untested one"). Similarly, while non-fund corporate boards might replace a CEO and one or two other top members of management, they do not, except in extraordinary circumstances, seek to replace the entire operational staff of the organization.

As explained, prudence alone suggests that directors replace advisers only in the most extraordinary of circumstances. But it should also not be forgotten that, when investors become shareholders of a fund, they have made a deliberate decision to select a particular investment manager whom they deem is best skilled to invest their money for them. Accordingly, absent truly extraordinary circumstances in which all other efforts to obtain improvements

within the existing management organization have failed, the selection of the adviser is best left to the individual investor and not the independent directors. *See, e.g.*, Tamar Frankel & Ann Taylor Schwing, The Regulation of Money Managers: Mutual Funds and Advisers § 9.04[D] (2d ed. 2008 Supp.) (directors are not required to shop around for the "cheapest" services; rather, "[o]nly when the adviser's performance or contract terms fall below minimal norms should the disinterested directors look for another").

Given the robust independence of modern-day fund boards, the variety of improvements that directors obtain from advisers, and the fact that, consistent with prudence and investor preferences, termination of the advisory contract should be a rare event, it can hardly be argued that independent directors do not stand in an arm's-length relationship with advisers. In reality, the overall fee-setting process works, as recognized by the SEC and further evidenced by declines in fund fees and expenses as shareholder services have increased. *See* ICI Br. Section II.C.2. Indeed, at least three well-trusted organizations—the SEC, the General Accounting Office and Lipper Analytic Services—have found mutual fund fees and expenses have declined over the years, particularly in the case of the larger and older funds and fund complexes.[5]

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[5] *See* SEC Fees Study; GAO, Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition (June 7, 2000) ("GAO Report") at 48–49, http://www.gao.gov/new.items/gg00126.pdf; The Third White Paper: *Are Mutual Fund Fees Reasonable?*, Lipper Analytic Services (Sept. 1998) ("Lipper Report") at 12.

In addition, directors have a variety of other tools for bringing fees down, such as breakpoints at specified asset levels, fee waivers, outright fee reductions, or service enhancements. For example, if there has been an increase in the number or quality of services provided by the adviser (such as increasing the size of the portfolio management team), the fee for the originally-provided services has in fact decreased, even if the overall amount of the fee (now paid for enhanced services) has stayed the same. Directors consider these, among numerous other factors, in evaluating fees.

Section 36(b) cannot be construed to render all of the foregoing a nullity. Yet that is essentially what petitioners and most of their *amici* propose. They would have courts review fees in the first instance, essentially relegating the independent directors to advisory status at best and to irrelevance at worst. That is not, however, the scheme that Congress enacted or the SEC has overseen since the 1970 Amendments. Section 36(b) must be implemented within that scheme, not as an alternative to it. The next section explains how.

II. Section 36(b)(2) Does Not Authorize Courts To Substitute Their Business Judgment For That Of Fund Directors

Concomitantly with strengthening the provisions for director independence, the 1970 Amendments added Section 36(b), which provides a private right of action against mutual fund advisers who have breached their "fiduciary duty" with respect to the receipt of "compensation." 15 U.S.C. § 80a-35(b). That section places the burden to prove such breaches on plaintiffs, and tasks courts to defer to the business judgment of the independent directors

where "appropriate under all the circumstances." *Ibid.*

Petitioners and most of their *amici* (with the exception of the United States) argue, however, that judicial deference to director decisionmaking is never appropriate because boards are allegedly captive to the advisers (Pet. Br. 5 n.3, 36), and that courts should instead engage in *de novo* review of certain *Gartenberg* factors in every instance to determine the appropriateness of advisory fees. *See, e.g.*, Pet. Br. 25 (arguing that even where there is no defect in the fee-approval process, courts should nonetheless scrutinize fees "for fairness"); *see also, e.g.*, Br. of NASAA 14 (arguing that courts must determine whether "fees are substantively fair or reasonable" even absent a showing of a defect in the approval process).

Petitioners' proposed standard fails because, as shown above, the independent-directors-as-captive argument is unrealistic, unsupported, and unsound. In addition, non-deferential review is irreconcilable with the text, structure, and legislative history of the statute, which establish that Congress did not intend for courts to substitute their judgment for that of the independent directors absent fundamental deficiencies in the approval process. To be sure, Congress did not intend for courts to defer blindly to the independent directors, either. *See* S. Rep. No 91-184 at 5 (1969) (noting that a "corporate waste" standard would be "unduly restrictive"). Rather, if (but only if) a plaintiff can prove that the board's approval was a mere formality, or that other fundamental deficiencies in the process precluded the board from making a business judgment, courts may review the fee *de novo*, utilizing factors such as those articulated in *Gartenberg*. In the absence of such proven deficiencies, however, the independent directors' review and

approval of the advisory fee is entitled to judicial deference.

A. Congress Directed Courts To Give Appropriate Weight To Director Approval

Section 36(b)(2) expressly provides that approval of adviser compensation by a fund's board of directors "shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). Petitioners' "statutory" analysis does not even cite this provision (Pet. Br. 20-34), envisioning no role for the court to give to the board's business judgment.

1. Petitioners' proposed non-deferential review cannot be reconciled with the clear text of Section 36(b)(2): If deference is never "appropriate" because of the purported failures in the bargaining process created by the mutual fund structure, then Section 36(b)(2) would be rendered a nullity. This Court must, of course, avoid such an interpretation. *See, e.g.*, *TRW Inc.* v. *Andrews*, 534 U.S. 19, 31 (2001) ("It is a cardinal principle of statutory construction that a statute ought, upon the whole, to be so construed that, if it can be prevented, no clause, sentence, or word shall be superfluous, void, or insignificant") (internal quotation and citation omitted).

"Appropriate" deference means that a court must defer to the independent directors' exercise of their business judgment in approving the advisory fees. In contrast, little or no deference may be due when the directors have demonstrably failed to exercise their business judgment—*i.e.*, when the directors' approval was a mere formality, or when there were other deficiencies in the approval process so fundamental that they precluded the board from making a

business judgment. If such fundamental deficiencies are proved, courts may review advisory fees *de novo*, utilizing factors such as those articulated in *Gartenberg*. And, of course, if a fee is not excessive under the *Gartenberg* factors, there is no private cause of action even if the approval process is imperfect.[6]

Indeed, the statutory structure compels this interpretation. As this Court explained in *Burks*, "Congress' purpose in structuring the Act as it did is clear. It 'was designed to place the unaffiliated directors in the role of independent watchdogs,'" and to give them "the *primary* responsibility for looking after the interests of the funds' shareholders." 441 U.S. at 484-85 (emphasis added). If courts were charged with determining in the first instance whether a given fee was "reasonable," without any deference to the expertise of those on whom this "primary responsibility" falls, courts would essentially usurp the "primary" role that Congress envisioned for the independent directors' approval under Section 15(c).

Thus, although petitioners contend that deference to director decisionmaking "renders § 36(b) superfluous in light of § 15(c)" (Pet. Br. 39), it is actually petitioners' proposed *de novo* judicial review of the reasonableness of advisory fees that would render the directors' duties under Section 15(c) meaningless. The better reading, which (unlike petitioners') harmonizes Section 15(c) and Section 36(b)(2), is

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[6] Section 36(b) only provides a private right of action for excessive fees. Thus, if a fee is not excessive, private plaintiffs do not have a cause of action even if there are fundamental deficiencies in the approval process. Such deficiencies may, of course, be addressed by the SEC under its review and enforcement powers. *See* 15 U.S.C. § 80a-41.

to allow non-deferential court review only where Section 15(c) fails to work—*i.e.*, where the directors' approval was a mere formality or there were other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment. In contrast, allowing courts to engage in *de novo* review of the reasonableness of fees without a failure in the 15(c) process would not only render 15(c) superfluous, but would also render the statutory scheme absurd.

Uniquely in the world of corporate governance, Congress charged the independent directors of mutual funds to undertake an annual review and approval of the advisory contract; Section 36(b) cannot be construed to render that express directive meaningless. When it enacted Section 36(b), Congress also enhanced Section 15(c), and the two sections were designed to work together. As this Court has recognized, "it would have been paradoxical for Congress to have been willing to rely largely upon 'watchdogs' to protect shareholder interests and yet, where the 'watchdogs' have done precisely that," require that their role be completely or significantly ignored. *Burks*, 441 U.S. at 484-85.

If there were any lingering doubt that Congress did not intend for courts to substitute their own judgment for that of the independent directors, it would be obliterated by the legislative history of the 1970 Amendments. The Senate Report explains that Congress did not intend for courts to "substitute [their] business judgment for that of the mutual fund's board of directors in the area of management fees." S. Rep. No. 91-184, at 6. Yet that is exactly what petitioners and most of their *amici* urge on this Court.

According to the Senate and House Reports, Section 36(b)(2) requires a court to determine whether the "deliberations of the directors were a matter of substance or a mere formality" and to weigh approval of directors accordingly. S. Rep. No. 91-184, at 15; H. Rep. No. 91-1382, at 37 (same). Thus, while a board's perfunctory approval based on sparse information might be entitled to little weight, an informed board's consideration of the relevant factors warrants substantial deference. Indeed, Congress's clear statement that Section 36(b) "is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the [directors] of such company to the judiciary" (S. Rep. No. 91-184, at 7) further confirms that courts should ordinarily defer to a board's determination of the worth of advisory services.

In addition, "[a]ttention must be paid as well to what Congress did *not* do." *Burks*, 441 U.S. at 483 (emphasis in original). Congress rejected an earlier legislative proposal that would have permitted courts to engage in reviewing the reasonableness of fees in the first instance, and later noted that nothing in the 1970 Amendments "is intended to ... suggest that a 'cost-plus' type of contract would be required. It is not intended to introduce a general concept of rate regulation as applied to public utilities." S. Rep. No. 91-184, at 5-6. But such rate-regulation is precisely what petitioners' new standard would entail by allowing courts to determine the reasonableness of fees *de novo* and substitute their non-specialist judgment for that of the congressionally sanctioned "watchdogs" operating under the close regulatory supervision of the specialist agency. That is an outcome that both Congress and this Court have eschewed. *See, e.g., Verizon Commc'ns* v. *FCC*, 535 U.S. 467,

539 (2002); *Town of Concord* v. *Boston Edison Co.*, 915 F.2d 17, 25 (1st Cir. 1990) (Breyer, C.J.) ("[H]ow is a judge or jury to determine a 'fair price'?").

Thus, unlike the unduly permissive *de novo* review proposed by petitioners, deferential review comports with—and is required by—Congress's intention to leave business decisions with decision-makers who are specialists in business issues, while at the same time protecting investors in those cases in which the specialist boards have demonstrably failed to exercise their business judgment.

2. Congress's highly deferential standard, under which courts are not to "substitute" their judgment for that of the independent directors, is one of the well-known formulations of abuse-of-discretion review. Under such review, the weight awarded by the board to each particular factor is not ordinarily second-guessed by the court, and thus the business judgment of the board cannot be disturbed even if the court might have reached a different decision. *See, e.g.*, *Gall* v. *United States*, 128 S. Ct. 586, 597 (2007) ("The fact that the . . . court might reasonably have concluded that a different [result] was appropriate is insufficient to justify reversal" of a decision reviewed for abuse of discretion).

"The prospect that perhaps a better bargain could have been driven is a slim justification for allowing courts to substitute their business judgment for the collective judgment of independent directors acting in good faith." Troy A. Paredes, Commissioner, SEC: Remarks Before the Mutual Fund Directors Forum Ninth Annual Policy Conference (May 4, 2009), http://www.sec.gov/news/speech/2009/spch050409tap.htm#14. Accordingly, although an especially large fee might show "that the decision-making

process that produced the fee may be inexcusably tainted, such as by disloyalty or a lack of adequate care . . . . , if careful, conscientious, and disinterested directors agree to the fee, little, if any, room is left for a court to declare that the fee is nonetheless so large that [it] could not be the result of an arm's-length bargain." *Ibid.*

In interpreting Section 36(b), it is important for the Court to give guidance to the lower courts on the appropriate level of deference owed to the independent directors' approval. Although *Gartenberg* recognized that the care and conscientiousness of independent directors are "important" considerations under Section 36(b), it did not elaborate on whether a court would place its own weight on each of the other *Gartenberg* factors, or would defer to the board's consideration of those factors absent a showing that the board's approval was a mere formality, or that there were other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment. Nor does the United States' *current* brief elaborate on this issue, although it similarly recognizes the important role of "the board's receipt of necessary information and its careful consideration of the *Gartenberg* factors," which the United States agrees "can be *strong* probative evidence that the adviser has complied with its fiduciary obligation." U.S. Br. 24 (emphasis added). (In this respect, the United States markedly diverges from petitioners and their other *amici*.)

This Court, however, should not permit courts to weigh (or reweigh) the *Gartenberg* factors anew absent proof of a fundamental deficiency in the approval process. There is simply no way to reconcile such *de novo* review with the type of review envisioned by Congress: that in which the independent

directors' approval receives its due, "appropriate" deference, in which directors have "primary" responsibility to review the fees, and courts are not to "substitute" their business judgment for that of the directors.

Indeed, in contrast to its lukewarm stance in this case, the United States has previously represented to this Court that "shareholder protection" is achieved by deferring to the "business judgment" of the independent directors, and that any other approach would evince "a failure to give proper consideration to the structure and purposes of the Act." Brief for the United States as Amicus Curiae, *Burks* v. *Lasker*, 441 U.S. 471 (1979), 1978 WL 207114, at *2-*3, *7-*9. What the United States said then is equally true today: "[T]he congressional goal of active stewardship by disinterested directors, performing their responsibilities in the best interests of shareholders, can be achieved by applying the traditional business judgment rule within a framework of safeguards." *Id.* at *3; *see also, e.g.*, Paul Roye, Director, SEC Div. of Inv. Mgmt., What Does It Take to Be an Effective Independent Director of a Mutual Fund (Apr. 14, 2000), http://www.sec.gov/news/speech/spch364.htm (a "court will not substitute its judgment for that of the director, provided that the director acted in good faith, rationally believed the action was in the best interest of the fund, and the director was reasonably informed").

3. Perhaps recognizing that the text, structure, and purposes of the Act do not support their position, petitioners rest their "statutory" analysis not on the Act itself, but rather on petitioners' selective analysis of the common law. *See* Pet. Br. 20-29.

Petitioners' common law arguments are largely beside the point. As an initial matter, it is inconceivable that, in enacting a new *federal* cause of action under Section 36(b), in the context of the most regulated sector of the securities industry, Congress intended that courts seek guidance not from the text, structure, and purposes of the Act, but from trust law concepts that were not incorporated into the Act. If anything, Congress's decision to reject the common law approach, under which the burden of proof would have been on the fiduciary, not on the plaintiffs as under Section 36(b), strongly suggests that Congress did not intend to incorporate the common law into the mechanics of federal court proceedings under Section 36(b), even if Congress might have envisioned a role for the common law with respect to other aspects of the 1940 Act.

While this Court sometimes looks to the common law to fill existing statutory gaps, there are no such gaps at issue in this case: Congress has expressly spoken to the role of the directors in both Section 15(c) and Section 36(b)(2) of the Act. The legislative history and Congressional policies underlying the Act could not have been clearer in rejecting an approach in which courts are permitted to determine the reasonableness of advisory fees in the first instance. *See, e.g.*, S. Rep. No. 91-184 at 6 (courts should not ordinarily "substitute" their judgment for those of independent directors "as to management fees").

And even if there were a statutory gap, the mutual fund structure is a hybrid creature of state and federal law that is without likeness at common law. Mutual fund investors are unlike beneficiaries involuntarily stuck with a trust set up by someone else for their benefit. Rather, they have made the voluntary

choice to invest in the mutual fund managed by the adviser, after full and clear disclosure of the fees. Nor can it seriously be said that advisers "control" funds overseen by boards composed predominantly of *independent* directors. Thus, despite the forced attempts by petitioners and their *amici* to fit mutual funds within one of the categories existing at common law, the common law is ultimately unenlightening as it does not address the unique governance structure at issue here.

The Court's decision in *Daily Income Fund* v. *Fox*, 464 U.S. 523, 540 (1984), is not to the contrary. There, the Court held that shareholders need not make a demand on the board prior to initiating a Section 36(b) suit. As Congress had rejected an earlier bill that had required boards to approve such demands, the Court remarked that "Congress decided not to rely *solely* on the fund's directors to assure reasonable adviser fees." *Id.* at 540 (emphasis added). Petitioners repeatedly read this statement out of context, hailing it as a sign that the independent directors' evaluation and approval of advisory fees deserve little or no deference. But there is nothing in the statement that "Congress decided not to rely *solely* on the fund's directors to assure reasonable adviser fees" that would prohibit a system in which, as *Burks* explained, directors have the primary responsibility to protect investor interests, and courts intervene where boards have failed to exercise that responsibility (*e.g.*, an inattentive board).

Nor did the Court in *Daily Income Fund* suggest that in reviewing a Section 36(b) challenge, a court is not to afford "appropriate" deference to the business judgment of the directors. To the contrary, while rejecting the concept that board approval of a suit's *initiation* is required, *Daily Income Fund* recognized

that board approval of adviser *compensation* requires "serious consideration." 464 U.S. at 540. The 1940 Act requires as much; yet petitioners would have courts give *no* consideration to the statutorily required approval of the advisory contract by the independent directors.

* * *

At bottom, petitioners' arguments add up to an attack on the entire mutual fund industry, as currently constituted under a congressionally mandated system. In that system, Congress relied principally, albeit not solely, on independent directors to protect investors against excessive fees, and tasked courts with deferring to the directors' business judgment absent a proven fundamental deficiency in the approval process. Arguments that this system should be changed, or additional substantive or procedural requirements imposed, may appropriately be directed to the political branches but they manifestly are not within the province of the Judiciary. Petitioners ultimately ask this Court to engage in the legislative act of authorizing federal district judges to sit in *de novo* review of business judgments made by independent directors of mutual funds. Since that is not the regime enacted by Congress, this Court cannot grant petitioners' request. *Cf. Tellabs, Inc.* v. *Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007).

B. Departing From That Congressional Directive Would Disserve Investors

Departure from the congressionally mandated deference owed to board decisions absent a fundamental deficiency in the fee approval process, even if it were within this Court's purview, would not be in the best interests of investors. Without such deference, plaintiffs' lawyers could find a basis to litigate the fees paid by virtually any mutual fund, as mere

disagreement with the amount or type of information the board reviewed or the weight the board placed on certain information would be sufficient to create an issue of fact for trial.

This case is illustrative. Although the independent directors of the Oakmark funds have *already considered* the reasons for the discrepancy between the fees paid by retail investors and those paid by institutional investors, and petitioners have not even attempted to show a fundamental deficiency in the fee-approval process, petitioners and their *amici* would nonetheless have this Court remand the case to the district court to consider this issue in the first instance. *See* U.S. Br. 32. Moreover, while petitioners' question presented focuses only on this one factor (*i.e.*, the purported discrepancy between "retail" and "institutional" fees) in requesting this Court to undo the board's approval, independent directors must consider and weigh a variety of factors and *all* the relevant circumstances before approving, or disapproving, an advisory contract.

For a court to undo the board's approval on remand based solely on one factor would require a court to afford a different weight than that given by the board not only to this factor, but also to the other factors considered by the board. Such second-guessing of the business judgment of the board is not in the best interests of investors. As explained, board approval involves multi-factor, multi-discipline, and often multi-year considerations that boards are best suited to provide. Boards have the time, expertise, and resources to understand and carefully analyze each issue, ask the right questions, and reach the right answer more often, more quickly, and more cheaply than courts. By contrast, it is no secret that the judicial machinery is ill-equipped to

make business judgments or determine fair prices. *E.g.*, *Verizon Commc'ns*, 535 U.S. at 539.

The independent directors of the Oakmark funds did not abuse their discretion in approving the advisory contract after considering the comparison between retail and institutional fees charged by the adviser. A quick perusal of the securities laws alone leaves no doubt that portfolio management services provided to institutional clients are significantly less regulated than portfolio management services provided to retail funds, and thus less costly. And notably, offering retail funds to the public entails a significantly greater litigation risk than offering services to institutional clients. In addition, institutional clients have lower liquidity requirements, and managing portfolios with lower liquidity requirements is less challenging, and thus less costly. *See, e.g.*, John C. Coates & R. Glenn Hubbard, Competition in the Mutual Fund Industry: Evidence and Implications for Policy, 33 J. Corp. L. 151, 185 (2007); ICI Br. Section I.D. Indeed, petitioners nowhere explain why regulatory, litigation, and liquidity-management costs of portfolio management are comparable for retail and institutional clients. *See* Pet. Br. 48-53. Because petitioners, the party bearing the burden of proof at trial, failed to present sufficient evidence creating an issue of fact for trial, the judgment below should be affirmed. Moreover, because many advisory contracts across the industry provide bundled contracts that cover myriad administrative functions or services beside portfolio management, petitioners' narrow focus on portfolio management fees alone has little relevance to a large number of cases.

The vague and overbroad disclosure-oriented test proposed by *Gallus* v. *Ameriprise Financial, Inc.*, 561

F.3d 816 (8th Cir. 2009), and echoed by petitioners, also would be detrimental to investors. Allowing Section 36(b) actions to go to trial based on the plaintiffs' mere disagreement with the amount or type of information the board reviewed—without proof that the directors' approval was a mere formality, or of other deficiencies in the approval process so fundamental that they precluded the board from making a business judgment—would result in excessive and costly litigation, and a disproportionate response to inconsequential mistakes, or even inconsequential misrepresentations, by the adviser. As inconsequential defects can be alleged in virtually every case, meaningful restrictions on the type of defect that could trigger *de novo* review are necessary to protect funds and investors against the costs and distractions of unwarranted litigation.

Indeed, under a contrary test, advisers would "have an incentive to submit a deluge of information that the [board] neither wants nor needs, resulting in additional burdens on the [board's] evaluation" in order to protect themselves against non-disclosure claims. *Buckman Co.* v. *Plaintiffs' Legal Comm.*, 531 U.S. 341, 351 (2001). Such information overload resulting from overdisclosure would not only fail to produce superior board decisions, but would also interfere with the board's efforts to produce informed, timely, and high-quality decisions.

This is not to say that every business judgment is above question, or that excessive fees cause no harm to investors. But federal securities litigation is clearly not the best method for redressing *that* harm. "Securities class actions cannot be justified as providing compensation," and those as to mutual fund fees make no exception. A.C. Pritchard, *Who Cares?*, 80 Wash. U. L. Q. 883, 884 (2002); *see also, e.g.*, In-

terim Report of the Committee on Capital Markets Regulation at 79 (2006) ("the notion that securities class actions do a good job of compensating injured parties is belied by data").

Nor is a deterrence justification warranted. Advisers already face significant deterrents. The SEC, which has broader exposure to the mutual fund industry than federal courts, and is better equipped to detect when a fiduciary is charging excessive fees, already monitors the fee approval process. Indeed, even absent investor complaints, the SEC conducts fund examinations regularly, and those examinations are designed to detect, among others, any improprieties in the fee-approval process. *See* GAO Report at 93. And, unlike private litigation, the SEC can utilize a panoply of remedies to calibrate its response to the seriousness of the conduct, ranging from an informal warning to an enforcement action. *See ibid.* (citing three instances of deficiencies related to the directors' role in reviewing fees uncovered by SEC examinations); *SEC* v. *Am. Birthright Trust Mgmt. Co.*, Litigation Release No. 9266 (Dec. 30, 1980) (directors approved advisory contracts without requesting information reasonably necessary to evaluate the contracts); *In re New York Life Investment Mgmt. LLC*, Litigation Release No. 28747 (May 27, 2009) (adviser did not provide board with information necessary to evaluate fee).

It is questionable whether the benefits of any additional marginal deterrence added by an expansive reading of Section 36(b) would exceed the costs of litigation's non-calibrated approach to punishment and deterrence. In addition, each of the costs will be ultimately borne by innocent investors, as increased fees to the advisers. Expanded litigation and discovery would also distract directors from overseeing the

fund. *See, e.g.*, *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 737-41 (1975); *Merrill Lynch, Pierce, Fenner & Smith, Inc.* v. *Dabit*, 547 U.S. 71, 80-82 (2006). As a result, even if directors are not defendants but mere witnesses in Section 36(b) lawsuits, rules that encourage such litigation would "deter" board service by the "qualified individuals" needed to perform the board's independent watchdog function, which would ultimately be detrimental to investors. *Dabit*, 547 U.S. at 81.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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AMICUS CURIAE BRIEF

No. 08-586 (19)

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE SUPPORTING RESPONDENT

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QUESTION PRESENTED

Amicus curiae Investment Company Institute will address the following question:

Whether the Court should endorse the longstanding framework established by the Second Circuit in *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (1982)—under which courts review an investment adviser's fee in light of a variety of factors and give considerable weight to independent directors' approval of the fee—as the proper way to assess claims that the adviser has breached its fiduciary duty with respect to the receipt of compensation in violation of Section 36(b) of the Investment Company Act of 1940.

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INTEREST OF AMICUS CURIAE[1]

The Investment Company Institute (ICI) is the national association of registered investment companies in the United States. ICI has three core missions: encouraging adherence to high ethical standards by all industry participants; advancing the interests of investment companies and their shareholders, directors, and investment advisers; and promoting public understanding of mutual funds and other registered investment companies. As part of its mission to promote public understanding of mutual funds, ICI pursues an extensive research program and is the primary source of aggregate industry data relied on by government regulators, industry participants, and independent observers.

As of 2008, ICI's members managed 98 percent of the roughly $10 trillion in mutual funds on behalf of more than 90 million investors in over 50 million households. Because of their ability to provide investors with diversified portfolios and a wide array of services, including professional investment management, mutual funds have proven to be the most convenient and cost-effective way for average Americans to achieve their retirement and savings goals. Mutual funds are comprehensively regulated and offer investors a high level of protection. Funds, their investors, and their advisers all have benefitted from the strong regulatory scheme set forth in the Investment Company Act of

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[1] Counsel for any party did not write this brief, in whole or in part. No person or entity other than amicus, its members, and its counsel has made a monetary contribution intended to fund the preparation and submission of this brief. This brief is filed with the written consent of all parties.

1940 (ICA), the Investment Advisers Act of 1940, the other major federal securities laws, and related rules of the U.S. Securities and Exchange Commission (SEC). ICI and its members have a strong interest in ensuring that this system of regulation, as intended by Congress, continues to serve both mutual funds and fund investors effectively.

This case involves Section 36(b) of the ICA, 15 U.S.C. § 80a-35(b), which provides that the investment adviser of a mutual fund "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services." ICI and its members have decades of experience applying Section 36(b) in ensuring that fund advisers meet this duty. As explained below, ICI's experience is that the standard set forth in *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982), especially as implemented in subsequent cases, represents the appropriate approach to judicial review of adviser compensation and is consistent with Congress's objectives in enacting the 1970 amendments to the ICA.

SUMMARY OF ARGUMENT

I. The proper standard for evaluating claims for a breach of fiduciary duty under Section 36(b) of the Investment Company Act (ICA) is that articulated in *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 928 (2d Cir. 1982). This standard has been consistently applied by the lower courts until the court of appeals decision in this litigation, and provides that a court should determine whether the fee received by an investment adviser "is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." *Gartenberg* has provided useful

guidance for investment advisers, fund directors, courts, and even the SEC for almost 30 years.

The *Gartenberg* court identified several factors to assist in determining whether a fee is so excessive as to constitute a breach of fiduciary duty, but also made clear that those factors were not exclusive, and that some might be more significant than others. During almost three decades of experience with *Gartenberg*, fund directors and courts have found, not surprisingly, that a central part of their analysis focuses on the nature and quality of the services investors are receiving and the price that investors could be expected to pay to other advisers that manage similar mutual funds providing comparable services.

Although petitioners and their *amici* nominally endorse *Gartenberg*, they in fact argue that courts should reject a comparison of fees charged by advisers to comparable mutual funds in favor of a comparison to fees paid by a fundamentally different type of client—and one that typically receives fundamentally different services from the adviser. Petitioners further argue that when engaging in a Section 36(b) analysis, courts should decide for themselves whether an advisory fee is "fair." This Court should reject those arguments. They rest on a highly inaccurate equating of mutual funds and non-mutual fund institutional accounts. They also disregard regulatory enhancements to mutual fund governance and fee-approval decisions that Congress, the SEC, independent directors, and the industry have put in place, as well as Section 36(b)(2), which instructs courts to give appropriate consideration to the fee-approval decisions of independent fund directors.

II. At bottom, petitioners' arguments in favor of a dramatically expanded role for the courts in scrutiniz-

ing advisory fees rest on a misapprehension about the state of the mutual fund industry. Petitioners describe it as uncompetitive, dysfunctional, and unresponsive to the interests of investors. The reverse is true in every respect. The mutual fund industry is virtually a textbook case of a competitive market, with many firms vying for cost-conscious investors. The industry has flourished over the past four decades because it has met these competitive challenges by providing investors with more investment choices and more services, all with declining costs.

ARGUMENT

Mutual funds operate under a regulatory regime arguably more comprehensive than that governing any other financial product. Funds must register with the SEC under the Investment Company Act of 1940 (ICA), and their securities must be registered under the Securities Act of 1933. Their investment advisers must register with the SEC under the Investment Advisers Act of 1940. These and other federal securities laws and related SEC rules impose upon funds and advisers detailed requirements relating to fund organization, governance, and capital structure, the disclosures funds and advisers must make, the offer and sale of fund shares to the public, and funds' daily operations.

In 1970, Congress amended the ICA to provide greater protection for investors against excessive adviser compensation. A centerpiece of this regime is Section 15(c) of the ICA, which requires substantive scrutiny by fund boards of investment advisory contracts and their terms, and further requires that advisory fees be approved by a majority of independent directors. In addition, the 1970 amendments strengthened the requirements for director independence. *See*

15 U.S.C. §§ 80a-2(a)(19), 80a-10. Section 36(b) was also added, in which Congress created a unique cause of action that allows fund shareholders or the SEC to proceed directly against an investment adviser for the alleged breach of a fiduciary duty with respect to the receipt of excessive compensation for advisory services. *See generally Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523 (1984). Congress directed courts, in actions under Section 36(b), to give such consideration to the fund board's approval of the advisory fee as is "appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2).

In the picture painted by petitioners and their *amici*, these and other regulatory protections built up over 30 years have been largely ineffective, and fund advisers unconstrained by any market forces take advantage of a captive, supine investor base. This picture is so distorted as to be unrecognizable. As we explain below, the courts have adopted a sensible and contextual framework for analyzing claims of excessive advisory fees that appropriately protects the interests of investors while steering clear of an unworkable *de novo* judicial scrutiny of adviser compensation. Nor are lawsuits the only protection afforded to investors: the improvements Congress made to fund governance are robust, and they operate to ensure that directors carefully and objectively scrutinize advisory fees. Appropriately, therefore, courts have generally given considerable weight to the decisions of independent fund directors to approve advisory fees. Evidence suggests that all of this has redounded to the benefit of investors; the mutual fund industry is highly competitive. Cost-conscious investors, with a world of information and choices available to them, have seen fit to trust funds with trillions of dollars of their money. And they have been rewarded, as the total cost of investing in

mutual funds has experienced a decades-long decline. Although petitioners contend that, because of market failure, much greater judicial intervention is needed to protect investors from advisers' supposed depredations, they have utterly failed to make a case for such a dramatic change in the legal standards governing adviser compensation.

I. THE *GARTENBERG* DECISION ARTICULATES THE APPROPRIATE FRAMEWORK FOR ASSESSING FEE CLAIMS UNDER SECTION 36(b)

A. This Court Should Adhere To *Gartenberg*'s Well-Tested Framework

In *Gartenberg* v. *Merrill Lynch Asset Management, Inc.*, 694 F.2d 923, 928 (1982), the Second Circuit held that "to be guilty of a violation of Section 36(b)," a fund adviser "must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." As respondent explains, that standard is consistent with the text, purpose, and legislative history of both Section 36(b) and the ICA as a whole. *See* Resp. Br. 26-30. The *Gartenberg* standard also draws from this Court's articulation of general fiduciary duty principles in *Pepper* v. *Litton*, 308 U.S. 295, 306-307 (1939), and appropriately tailors them to the unique context of mutual funds. *See* Resp. Br. 27-28. The United States would seem to concur in respondent's view of *Gartenberg*. U.S. Amicus Br. 11. Courts also have overwhelmingly agreed; until the court of appeals decision in this litigation, the *Gartenberg* standard had been consistently applied in cases

alleging that a fund adviser had breached its fiduciary duty under Section 36(b).[2]

The *Gartenberg* decision also sets forth a flexible analytical framework that courts have found useful in Section 36(b) cases. The Second Circuit's opinion identified several factors that may be important in "determining whether a fee is so excessive as to constitute a 'breach of fiduciary duty.'" *Gartenberg*, 694 F.2d at 930; *see also* pp. 9-12, *infra*. The court nevertheless made clear that the factors it identified were not exclusive, 694 F.2d at 929 (noting that "all pertinent facts must be weighed"), and that certain factors might be more significant than others, *id.* at 930.

The salient point about the *Gartenberg* framework is that it is sensitive to context, and so it allows a court hearing a Section 36(b) claim to decide which factors are most relevant to the case before it. *See, e.g., Amron* v. *Morgan Stanley Investment Advisors, Inc.*, 464 F.3d 338, 344 (2d Cir. 2006); *see generally* Martin, *Litigation Under the Investment Company Act of 1940*, in 2 Kirsch, *Mutual Fund Regulation* 26-11 (2d ed. 2009) ("In weighing whether a fee is excessive, courts consider all facts and circumstances surrounding the receipt of compensation[.]"). As the courts have gained

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[2] *See, e.g., Amron* v. *Morgan Stanley Inv. Advisors, Inc.*, 464 F.3d 338, 340-341 (2d Cir. 2006); *Krantz* v. *Prudential Invs. Fund Mgmt. LLC*, 305 F.3d 140, 143 (3d Cir. 2002) (per curiam); *Migdal* v. *Rowe Price-Fleming Int'l*, 248 F.3d 321, 326 (4th Cir. 2001); *Forsythe* v. *Sun Life Fin., Inc.*, 417 F. Supp. 2d 100, 114 (D. Mass. 2006); *In re Dreyfus Mut. Funds Fee Litig.*, 428 F. Supp. 2d 342, 349 (W.D. Pa. 2005); *Zucker* v. *AIM Advisors, Inc.*, 371 F. Supp. 2d 845, 848 n.5 (S.D. Tex. 2005); *Krantz* v. *Fidelity Mgmt. & Research Co.*, 98 F. Supp. 2d 150, 158 (D. Mass. 2000); *King* v. *Douglass*, 973 F. Supp. 707, 722 (S.D. Tex. 1996).

experience with Section 36(b) claims over the decades, they have generally concluded that certain factors identified in *Gartenberg* are more likely to be relevant than others, while not closing the door as a matter of law to considering other factors, whether listed in *Gartenberg* or not. *See* pp. 9-12, *infra*.

The result has been the development of a remarkably stable and cohesive body of law that has provided welcome guidance, in particular, to advisers and to fund boards tasked with evaluating advisory fee proposals. As the United States notes, "[t]he *Gartenberg* standard—along with its non-exclusive list of potentially relevant factors"—offers guidance to both "fund boards fulfilling their obligation under Section 15(c) of the ICA of evaluating advisers' compensation" and "advisers in proposing fees." U.S. Amicus Br. 24. Indeed, the SEC itself has incorporated "*Gartenberg*-like" factors into its regulations requiring disclosure in fund shareholder reports and proxy statements of the basis for the directors' decision to approve the fund's advisory contract and the adviser's fee. *Id.* at 23. In the SEC's view, this transparency regarding the fees paid under advisory contracts encourages "boards to engage in vigorous and independent oversight of advisory contracts." *Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies*, 69 Fed. Reg. 39,798, 39,799 (June 30, 2004). *Gartenberg*, as implemented through these SEC disclosure requirements, establishes a framework that provides directors with useful guidance about the categories of information that they should request and scrutinize when reviewing the fund's advisory contract and has led to meaningful improvements in that review process. *See generally* IDC Amicus Br. 11-13.

The *Gartenberg* standard also allows courts to weed out meritless claims before trial while providing real and substantial protection to investors—both by reinforcing and clarifying boards' obligations to review advisory fee proposals thoroughly, and by holding open the prospect of a judicial recovery should a plaintiff be able to show that the advisory fee "bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining." 694 F.2d at 928. That standard is demanding, as it should be—especially when the fund's board has properly carried out its obligations of reviewing the fee proposal—but it is not insuperable. Petitioners' *amici* suggest that the *Gartenberg* standard is inadequate to protect investors because plaintiffs have never prevailed on the merits in a litigated Section 36(b) case (*see* Law Prof. Amicus Br. 4; NASAA Amicus Br. 3; NASCAT Amicus Br. 15), but they ignore that only a handful of Section 36(b) cases have been litigated to final judgment since *Gartenberg*, whereas numerous Section 36(b) cases have been resolved by the parties without dismissal on dispositive motion or trial, and some of those settlements have included an agreement to lower fees. These results severely undermine the contention that the *Gartenberg* standard is inadequate to protect investors.

B. Past Experience Is Instructive As To The Relative Weight To Be Accorded To The *Gartenberg* Factors

Courts analyzing Section 36(b) claims have generally focused on three factors: (1) the nature and quality of the services provided by the fund adviser (*i.e.*, what fund investors get for what they pay), (2) the fees charged by comparable mutual funds, and (3) the ex-

pertise, care, and conscientiousness of the fund's independent directors who evaluated and approved the advisory fee. *See, e.g., Migdal* v. *Rowe Price-Fleming Int'l*, 248 F.3d 321, 326 (4th Cir. 2001); *Kalish* v. *Franklin Advisers, Inc.*, 742 F. Supp. 1222, 1229 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 590 (2d Cir. 1991); *Schuyt* v. *Rowe Price Prime Reserve Fund*, 663 F. Supp. 962, 974-977 (S.D.N.Y. 1987), *aff'd*, 835 F.2d 45 (2d Cir. 1987); *see also* Martin, *supra*, at 26-16 to 26-17.

It is entirely sensible that these factors should be the most useful ones in reviewing Section 36(b) claims. Although courts are not expert in investment management and should give considerable weight to the board's business judgment regarding an adviser's services, performance, and fees, in the end the fundamental question under Section 36(b) is whether investors are receiving services and performance that bear a "reasonable relationship" to what advisers are charging them.[3]

Courts have found a useful benchmark against which to measure advisory fees to be the fees charged by other mutual fund advisers for those services that are comparable in scope and quality. Likewise, in the fee-approval process, boards have found that compari-

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[3] Courts have recognized, however, that underperformance of a fund generally is not sufficient by itself to establish that an advisory fee was excessive. *See Migdal*, 248 F.3d at 327-328 ("Accepting plaintiff's invitation to permit discovery ... because the funds underperformed would make it possible for other plaintiffs to state a claim in limitless actions filed under Section 36(b)"); *see also* Pet. Br. 51 ("Regardless, § 36(b) imposes a fiduciary duty with respect to 'compensation,' not performance. Focusing on the latter would make poorly performing funds especially vulnerable to suit, a result benefiting neither investment advisers nor investors.").

son to be central to their inquiry. When (as appears to be true in this case) the advisory fee, services offered, and performance are well within the range offered by competitors, it should be difficult for a court to conclude that the fee "could not have been the product of arm's-length bargaining."

By contrast, courts have generally found other factors less useful in determining whether advisory fees are within the range that could have been negotiated through arm's-length bargaining. For example, the profit that an adviser earns from managing a particular fund—although mentioned in the *Gartenberg* decision—has been of limited use in evaluating whether advisory fees are excessive.[4] In addition, although the *Gartenberg* decision included them as factors, courts since *Gartenberg* have not found the existence of so-called

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[4] Calculating the profitability of a single fund in a multiple-fund complex is enormously complicated and is especially difficult when, as is often the case, an adviser provides multiple services to a fund and the exact allocation of payments to each function is uncertain, or when advisory services to the fund are only one element of a larger financial product or package of financial services offered by an adviser or its affiliates. *See, e.g., Krinsk* v. *Fund Asset Mgmt., Inc.*, 715 F. Supp. 472, 489 (S.D.N.Y. 1988), *aff'd*, 875 F.2d 404 (2d Cir. 1989) ("Calculation and allocation of costs against different product lines or, in this case, among different segments of the same product, is an art rather than a science. Little certainty exists in this field where different, albeit rational, methodologies lead to widely disparate results."); *Schuyt*, 663 F. Supp. at 978 (characterizing the "task of calculating the [fund adviser's] exact cost of servicing" the fund as "virtually impossible"); *see also* Martin, *supra*, at 26-12. The legislative history, moreover, makes clear that "[an] investment adviser is entitled to make a profit. Nothing in [Section 36(b)] is intended to imply otherwise or to suggest that a 'cost-plus' type of contract would be required." S. Rep. No. 91-184 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4902-4903.

"fall-out benefits" to the adviser, or the extent to which the adviser shares economies of scale with investors, to be particularly instructive in evaluating Section 36(b) claims.

Ultimately, the *Gartenberg* decision identified factors as guideposts that might be considered in a diverse range of cases. That decision did not suggest that each factor must be given weight, much less equal weight, in every case. And since *Gartenberg*, courts have demonstrated that they are capable of applying those factors in a sensible way. This cohesive body of case law has served investors and the industry well.

C. A Court Deciding A Section 36(b) Claim Normally Should Give Considerable Weight To The Fee-Approval Decision Of The Fund's Independent Directors

The *Gartenberg* court remarked that the experience, care, and conscientiousness of the independent directors who reviewed and approved a fund's advisory fee should be an "important" factor guiding a court's evaluation of a claim that the adviser had charged an excessive fee. *Gartenberg*, 694 F.2d at 930. That observation was well-taken.[5] Section 36(b) does not stand alone in providing protection to investors against excessive adviser compensation; rather, the *first* line of investor protection against such fees is a unique system of fund governance. That system emphasizes the inde-

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[5] The Solicitor General agrees, for she notes that "the board's receipt of necessary information and its careful consideration of the *Gartenberg* factors prior to approving compensation can be strong probative evidence that the adviser has complied with its fiduciary obligation." U.S. Amicus Br. 24.

pendence of fund boards and the role of the independent directors, who form the "cornerstone of the ICA's effort to control conflicts of interest." *Burks* v. *Lasker*, 441 U.S. 471, 482 (1979). Congress in fact "entrusted to the independent directors ... the *primary responsibility* for looking after the interests of the funds' shareholders." *Id.* at 484-485 (emphasis added).

Amendments adopted in 1970 along with Section 36(b) strengthened the standards under which directors would be deemed to be "independent" of the fund's adviser, and greatly expanded the role of fund boards and their independent directors in evaluating and approving adviser compensation. Section 10(a) of the ICA, 15 U.S.C. § 80a-10(a), requires that not less than 40 percent of a fund's board of directors be independent of the adviser; in practice, most funds go well beyond this mark.[6] Congress also significantly enhanced Section 15(c), *id.* § 80a-15(c), by imposing an affirmative duty on the board to request (and a corresponding duty on the fund adviser to provide) all information that "may reasonably be necessary to evaluate the terms" of the advisory contract. Section 15(c) further requires the fund's independent directors to approve the fee to be paid to the adviser. The SEC has since required fund shareholder reports and proxy statements to discuss factors related to that approval, including certain

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[6] According to a 2006 survey, independent directors made up at least three quarters of the board at eighty-eight percent of fund complexes participating in the survey, and seventy-eight percent of fund complexes had an independent board chair or an independent lead director. *See* ICI & IDC, *Overview of Fund Governance Practices 1994—2006*, at 6 (2007). *See generally* IDC Amicus Br. 6-8.

factors based on *Gartenberg*. *See* 69 Fed. Reg. at 39,801 & n.31.[7]

Given Congress's strengthening of the role of the independent directors, it is not surprising that Congress also expressly required, in Section 36(b)(2), that courts give "such consideration ... [to board decisions under Section 15(c)] as is deemed appropriate under all

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[7] Petitioners and their *amici*, seeking to dramatically expand the courts' appropriate scope of inquiry in Section 36(b) cases, suggest that Section 36(b) imposes a freestanding obligation on the adviser of "full disclosure" to the board that would provide an alternative basis for liability, even in cases where a failure to disclose certain information has no demonstrated impact on the adviser's fee. *See* Pet. Br. 33; AARP Amicus Br. 4; *see also Gallus* v. *Ameriprise Fin., Inc.*, 561 F.3d 816 (8th Cir. 2009), *petition for cert. pending*, No. 09-163. That contention is not properly presented in this case, where petitioners have not alleged that respondent violated Section 36(b) with respect to the disclosure it provided to the board. Should this Court reach that question, it should conclude that Section 36(b) does not provide a private right of action on this theory. To conclude otherwise would contravene the statutory text, which expressly limits the private right of action to a breach of an adviser's fiduciary duty with respect to the "receipt of compensation for services." *See Migdal*, 248 F.3d at 328 ("Section 36(b) is sharply focused on the question of whether the fees themselves were excessive[.]"); *Forsythe* v. *Sun Life Fin., Inc.*, 417 F. Supp. 2d 100, 115 (D. Mass. 2006) ("[Section] 36(b) is not a general vehicle for bringing claims for any and all purported breaches of fiduciary duty; claims under the statute must allege some connection between the wrongs alleged and excessive compensation of an investment adviser or affiliated persons."). The United States appears to agree. *See* U.S. Amicus Br. 15 (noting that Congress "could have accomplished [such a] purpose much more clearly and directly by authorizing damages suits for violations of the disclosure and anti-fraud provisions" and that "[f]ailure to disclose ... could reasonably be regarded as 'personal misconduct' " enforceable solely by the SEC under ICA § 36(a)).

the circumstances." 15 U.S.C. § 80a-35(b)(2).[8] Petitioners virtually ignore this provision when they argue that the Court should interpret Section 36(b) to require, in effect, *de novo* judicial review of every fee approval decision for "fairness." But the approach that is more faithful to the *entire* statutory text, as well as more likely to yield a reasonable balancing of the interests of investor protection, judicial economy, and deterrence of meritless lawsuits, is the one followed by the lower courts since *Gartenberg*: giving considerable weight to the fee-approval decision of the fund's independent directors.[9]

D. The Fees Paid By An Adviser's Non-Mutual Fund Institutional Clients Generally Deserve Little Weight

Despite paying lip service to *Gartenberg*, petitioners and some of their *amici* seek to fundamentally alter its framework by suggesting that a disparity between the fees an adviser receives from a mutual fund and those it receives from its non-mutual fund institutional clients is dispositive or "highly probative" in most cases. Pet. Br. 18, 30, 51; NASAA Amicus Br. 4. Indeed, petitioners claim that a violation of Section 36(b) can be established solely upon evidence that a fund's

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[8] The legislative history is in accord: Congress cautioned that Section 36(b) was "not intended to authorize a court to substitute its business judgment" for that of the fund's board. S. Rep. No. 91-184, at 7 (1970).

[9] *See, e.g.*, *Krinsk* v. *Fund Asset Mgmt.*, 875 F.2d 404, 412 (2d Cir. 1989); *Kalish*, 742 F. Supp. at 1241; *Schuyt*, 663 F. Supp. at 977; *Pfeiffer* v. *Bjurman, Barry & Assocs.*, No. 03 Civ. 9741, 2004 WL 1903075, at *4 (S.D.N.Y. Aug. 26, 2004); *see also* Fidelity Amicus Br. 6-9.

advisory fee is "significantly higher for *comparable* services" than the fees paid by the adviser's non-mutual fund institutional clients. Pet. Br. 18 (emphasis added). The fundamental flaw in petitioners' assertions is that, in reality, these are very different types of advisory clients, and the services those clients receive generally are *not* comparable. In fact, comparisons between the fees paid to an adviser by mutual funds and by non-mutual fund institutional clients can be highly misleading, for several reasons.

First, the services offered to mutual fund investors and to non-mutual fund institutional clients are generally quite different, reflecting the different clienteles to which they are provided. Mutual funds are often offered to the public with very low minimum initial investment requirements, sometimes $500 or less; fund investors consequently have vastly lower account balances, on average, than non-mutual fund institutional clients. *See* ICI, *Mutual Funds and Institutional Accounts: A Comparison* 4 (2006) (average balance in a long-term retail fund account is less than $27,000; average balance in a non-mutual fund institutional account is more than $41 million). At the same time, fund investors have come to expect a more varied array of services than non-mutual fund institutional clients generally receive. Advisers often provide mutual fund investors with around-the-clock customer support, extensive websites, check-writing privileges, automatic investment programs, and tax reporting services, in addition to professional portfolio management. Services for non-mutual fund institutional clients are tailored to their more limited needs, and usually focus principally on portfolio management.

In addition, the business of advising mutual funds involves significantly greater entrepreneurial risk than

advising non-mutual fund institutional clients. The mutual fund model—in which the firm holds itself out to the public and seeks to attract a large number of relatively small investors—requires an adviser to take on substantial entrepreneurial risk and make a long-term commitment of capital. Advisers often heavily subsidize a fund until it attracts enough investors to be profitable. By contrast, non-mutual fund institutional clients usually invest a significant block of assets upfront, and frequently commit to invest with the adviser for several years.

Even portfolio management—the one feature mutual funds and institutional accounts generally have in common—differs significantly between the two. Mutual fund advisers must manage fund assets with a constant eye to investors' daily share purchases and redemptions. By contrast, institutional accounts often have more predictable cash flows.[10] A mutual fund's more frequent cash flows complicate portfolio management by requiring more purchases and sales of securities and additional rebalancing of the fund's portfolio. *See* ICI, *Mutual Funds and Institutional Accounts: A Comparison* 6-7 (2006). Advisers also face regulatory requirements that uniquely affect mutual fund portfolios, such as diversification requirements, limitations on leverage, and specific restrictions on certain types of investments. Mutual fund investors are also more likely than non-mutual fund institutional clients to be

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[10] Flows in non-mutual fund institutional accounts are often predictable because the terms of the arrangement may restrict the institutional client's ability to make redemptions or require it to provide advance notice of large redemptions or purchases. Such terms are included precisely because of the complexities involved in managing large unexpected cash flows.

invested through taxable accounts. Consequently, mutual fund advisers are more likely to take tax effects into account in their portfolio transactions. Due to all these additional requirements, managing a mutual fund portfolio is generally more complicated than managing a non-mutual fund institutional account.

Finally, the legal structures governing mutual funds and non-mutual fund institutional accounts are entirely different. Mutual fund advisers incur substantial costs in creating and maintaining a compliance and regulatory support infrastructure that allows them to operate in their highly regulated environment. They prepare prospectuses, shareholder reports and other disclosures for which they have liability under the securities laws. And they oversee securities pricing, custody and shareholder transaction processing operations, which often involves contracting with and supervising fund accountants, custodians, auditors, transfer agents, and other service providers. Advisers to institutional accounts are able to operate with a far less elaborate infrastructure and without many of the costs that an adviser to mutual funds must incur.

For all of these reasons, courts have recognized in a number of instances, based on an assessment of the facts of particular cases, that the fees charged by an adviser to its non-mutual fund institutional clients were not a relevant benchmark in evaluating whether the compensation the adviser received from the fund was excessive under Section 36(b). *See, e.g.*, *Baker* v. *American Century Inv. Mgmt., Inc.*, No. 04-4039-CV-C-ODS, Order 1 (W.D. Mo. filed July 18, 2006); *Strougo* v. *BEA Assocs.*, 188 F. Supp. 2d 373, 384 (S.D.N.Y. 2002). The United States also appears to recognize that a comparison to fees paid by the adviser's non-mutual fund institutional clients may be inapt. *See* U.S.

Amicus Br. 31 n.10 ("The comparison to fees paid by unaffiliated institutional clients ... raises the question whether the services provided to different kinds of entities were in fact comparable."). This Court need not conclude that such a comparison is *per se* irrelevant, but given the considerable differences between mutual funds and non-mutual fund institutional accounts, that comparison will rarely, if ever, be useful to a fund board, or to a court deciding a Section 36(b) case.[11]

II. THE MUTUAL FUND INDUSTRY IS A DYNAMIC, COMPETITIVE INDUSTRY THAT PROVIDES SUBSTANTIAL BENEFITS TO INVESTORS

For nearly three decades, the *Gartenberg* framework has provided fund boards and advisers with useful guidance, ensured investor protection, and served judicial economy by not embroiling the courts in technical disputes over business judgment. Petitioners nevertheless urge a significant change in the relevant legal regime. They contend that, under the common law of trusts, courts would have exercised their own independent judgment as to whether a trustee's compensation was "fair" or "reasonable," and so courts hearing Section 36(b) claims should too. Underlying this sub-

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[11] As explained in the IDC Amicus Brief (at 12, 30-31) and the Fidelity Amicus Brief (at 11-20), a fund's directors are best positioned to make the determination, based on the information presented to them, whether a comparison of mutual funds and non-mutual fund institutional account fees is relevant in a particular case, and courts generally should defer to their judgment on that point. As the United States points out, SEC regulations require boards to disclose in proxy statements and shareholder reports the consideration, if any, they give to the fees that their advisers charge to other clients. *See* U.S. Amicus Br. 30.

mission is a contention that the mutual fund industry presents a case of dramatic market breakdown, in which investors can learn little about how much they are paying and what they are paying for, and fund advisers consequently have free rein to take advantage of them. *See, e.g.*, Pet. Br. 43; Bogle Amicus Br. 29-30; Litan Amicus Br. 7-15, 18-21.

Respondent and other *amici* address more directly the doctrinal flaws with petitioners' argument, in particular the errors in their contention that Congress intended to import wholesale the common law of trusts into Section 36(b). It bears emphasis, as well, that petitioners surely have the burden of proving that the dramatic departure from settled law that they propose is in fact needed. Not only has that case not been made; it is refuted by a factual review of the mutual fund industry. Contrary to petitioners' distorted picture of the mutual fund industry as uncompetitive and dysfunctional, the industry is in fact competitive and vibrant and provides significant benefits to investors—as demonstrated by the enormous growth in popularity of mutual fund investing over the last four decades.

A. Petitioners Misunderstand The Fundamental Economic Relationship Between A Fund And Its Adviser

A key assumption that petitioners and their *amici* make is that competition does not exist among mutual funds because fund boards rarely replace fund advisers. *See, e.g.*, Pet. Br. 26; Bogle Amicus Br. 9, 30; AARP Amicus Br. 15-20. This argument is premised on the assumption that fund boards, rather than fund investors, are the key fund "customers." This inaccurate assumption obscures the business and economic realities

of what a mutual fund is and how competition arises in the industry.

Legally, a mutual fund is a corporation or business trust that pools the assets of a large number of investors to provide them with diversification and professional management. As a practical matter, however, a mutual fund operates as a vehicle through which an investment adviser can offer those services to the fund's investors. The adviser makes the long-term commitment of capital required to create and sustain the costly and complex infrastructure that a fund needs to operate, and also bears the associated entrepreneurial risk. The adviser typically undertakes research and development, incurs the expense of setting up the fund and complying with applicable laws and regulations, provides the fund's start-up capital, and arranges for both its promotion and sale to the public and for the provision of numerous support services to its investors. The adviser also usually provides, directly or indirectly, the portfolio managers, accountants, lawyers, office space, computers, internet connections, telephone systems, securities trading systems, and backup facilities necessary to allow a mutual fund to provide services to investors.

Indeed, investors usually choose a mutual fund precisely for the benefit of the totality of the adviser's services.[12] And fund investors themselves can and do "re-

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[12] This understanding of the economic relationship between a fund and its adviser has informed the ICA from its inception. As one of the ICA's drafters noted, "[T]he board of directors does not act in a vacuum.... [The] stockholders either have chosen the existing management or they have bought their shares in probable reliance on such management. Presumably, they have confidence in the management and would not expect the directors to take ac-

place" investment advisers by redeeming their shares and taking their money to another fund or another investment product. Focusing narrowly on the relationship between the adviser and the fund *board* thus misses the essence of mutual fund activity: to survive and flourish, advisers must provide acceptable services at an acceptable price to *investors*, and (as explained below) investors have no hesitation in going elsewhere if advisers fail to meet their expectations.

B. Petitioners Likewise Mischaracterize The Mutual Fund Marketplace

Petitioners and their *amici* suggest that more intrusive judicial review of advisory fees is needed because investment advisers generally do not compete for the business of managing the investments of particular mutual funds. *See* Pet. Br. 26; Bogle Amicus Br. 7-8, 29. What this argument overlooks is that competition among mutual fund advisers to manage investors' dollars is vigorous. Investors, typically with the assistance of brokers or other financial advisers, can shop for the best deal before they make an initial purchase in a fund. On any given business day, if shareholders are dissatisfied with the investment performance, fees, or services of a given fund, they can easily redeem their shares for cash and invest elsewhere.

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tion to change it except in unusual circumstances." *See* Jaretzki, Jr., *Duties and Responsibilities of Directors of Mutual Funds*, 29 Law & Contemp. Probs. 777, 786 (1964).

1. The mutual fund marketplace is highly competitive

The market in which fund advisers compete to manage investors' dollars is highly competitive.[13] A standard textbook model of a competitive market is that the market comprises a large number of consumers and firms, is not dominated by any one firm or group of firms, and has low barriers to entry and exit. This is an apt description of the market for mutual funds in the United States.

The fund marketplace has a large number of investors, funds, and advisory firms sponsoring funds. In 2008, an estimated 92 million individual investors in 52.5 million households owned mutual funds. *See* ICI, *Investment Company Fact Book* 73 (49th ed. 2009) ("*Fact Book*").[14] These investors could choose from 8,022 funds offered by 717 advisory firms. All these firms compete on the basis of a variety of factors, in-

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[13] Regardless of how one interprets Section 36(b), we agree with Judge Easterbrook that "[m]utual funds come much closer to the model of atomistic competition than do most other markets." *Jones* v. *Harris Assocs. L.P.*, 527 F.3d 627, 634 (7th Cir. 2008). The value of comparing one mutual fund's fees with another's, as *Gartenberg* contemplates, and as was emphasized in the opinion below by Judge Easterbrook, is all the more apparent in light of the highly competitive nature of the mutual fund industry.

[14] ICI's *Fact Book*, which has been published for 49 years, is an annual compendium of information about mutual funds and other registered investment companies, derived in large part from primary data provided by ICI member firms. The *Fact Book* is widely cited by fund advisers and boards, policymakers, academics, and the media as an authoritative source of information about mutual funds. ICI has been analyzing trends in mutual fund fees and expenses year-by-year since 1996.

cluding price, performance and services. No advisory firm dominates the U.S. fund business: the largest five firms manage slightly more than one third of mutual fund assets, and the top ten manage only about one half. *Id.* at 21. A standard measure used to assess industry competitiveness indicates that the mutual fund market is well in the competitive range.[15]

The industry also has low barriers to entry and exit, hallmarks of a competitive market. *See Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 591 (1986). Potential opportunities in the fund industry have induced many new advisers with innovative products to enter the market. According to one measure, the number of fund advisers almost tripled from 1985 to 2004. *See* Coates & Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 165 (2008); Law & Finance Amici Br. 20. In 2008 alone, thirty-five new advisers entered the market. Because firms can easily enter and exit the market, no one firm can charge fees above a competitive level—a level in large part determined by the total value of services and performance the adviser makes available through a particular fund.

There also is a clear Darwinian winnowing out of less competitive advisers from the fund marketplace.

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[15] The Herfindahl-Hirschman Index (HHI), a standard measure of industry concentration, clearly indicates that the market for mutual funds is unconcentrated. An index level below 1000 generally indicates that an industry is unconcentrated. *See* Dep't of Justice & FTC, *Horizontal Merger Guidelines* § 1.51 (rev. 1997), *available at* http://www.usdoj.gov/atr/public/guidelines/hmg.htm. The index level for the mutual fund market was 433 in December 2008. *See Fact Book* 21.

In 2008 alone, thirty-seven advisers left the market, and several dozen left in each of the previous seven years. Moreover, the largest, most successful firms have had to compete intensely to stay there; of the firms that were among the twenty-five largest in 1985, only *ten* remained in that position in 2008. *Id.* at 21. Individual funds also commonly come and go, in response to investors' preferences. In this decade, fund advisers have on average created 689 new mutual funds each year and liquidated 277. *Id.* at 14. Almost 600 new funds were created in 2008 alone, and nearly 300 were liquidated. *Id.*

2. Investors have ready access to a wealth of information about every mutual fund, including its fees

Competition in the fund industry has been greatly facilitated by investors' ready access to information necessary to compare fund fees. Indeed, the information that mutual funds disclose, either by law or choice, is far greater than that available for other investment products, including the types of non-mutual fund institutional accounts petitioners argue must be used as the point of comparison.

SEC regulations have long required mutual funds to make clear and detailed disclosures to investors about their fees. As early as 1988, the SEC began requiring funds to include fee information in a standardized tabular format at the front of their prospectuses. *See Consolidated Disclosure of Mutual Fund Expenses*, 53 Fed. Reg. 3192, 3196-3197 (Feb. 4, 1988). In 1998, this fee table was included in the newly added prospectus risk/return summary—an " 'executive summary' of key information about the fund in a standardized, easily accessible place that investors could use to

evaluate and compare the fund to others." *See Registration Form Used by Open-End Management Investment Companies*, 63 Fed. Reg. 13,916, 13,919 (Mar. 23, 1998). More recent SEC rules require a summary section in the front of each prospectus and permit the use of a "summary prospectus," both of which prominently feature this information. *See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, 74 Fed. Reg. 4546, 4589-4590 (Jan. 26, 2009).

Information about fund fees is also readily available elsewhere. Advisers generally provide on their websites detailed information about the funds they sponsor, including the funds' fees. Brokers and other financial advisers often provide their clients with similar information. *See* ICI, *Ownership of Mutual Funds Through Professional Financial Advisers, 2007*, at 1 (2008). Information about funds and their fees is widely provided on popular Internet websites.[16] Morningstar and Lipper offer comprehensive research coverage and fee and performance analyses of almost the whole universe of funds. In addition, the popular press frequently features articles on fund fees. *See, e.g.*, Damato, *How Well Do You Know ... Fund Expenses?*, Wall St. J., July 8, 2009, at R22. And all of this does not even take into account information on funds provided by brokers and mutual fund "supermarkets," which are brokerage platforms that provide investors with access to funds from a wide range of fund families.

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[16] *See, e.g.*, Yahoo Finance Page: http://finance.yahoo.com; Google Finance Page: http://www.google.com/finance; CNNMoney.com: http://money.cnn.com/; and Marketwatch.com: http://www.marketwatch.com.

3. Investors have demonstrated a high degree of sensitivity to the level of fund fees

Investors demand good performance from their mutual funds. Because fund fees can significantly influence fund performance, investors are keenly sensitive to fund fees. Indeed, survey data indicate that for a majority of investors, one of the most important factors they consider before purchasing a mutual fund is its fees. *See* ICI, *Understanding Investor Preferences for Mutual Fund Information: Summary of Research Findings* 3 (2006). These findings directly contradict certain *amici*'s assertions that investors are effectively unable to learn or understand what fees are charged by mutual funds. *See* Law Prof. Amicus Br. 25-26; Litan Amicus Br. 7-15.

The surest sign that investors are responsive to fund fees is to compare what they buy with what the market offers for sale. Although some investors select funds with shareholder services or investment performance that may command higher fees, investors generally gravitate towards lower-cost funds. For example, in the ten-year period ending in 2008, funds with below-average prices attracted money from investors, whereas funds with above-average prices saw investors withdraw money. *See Fact Book* 62-63.

Further evidence that investors are sensitive to fees is that they vote with their feet, moving money between advisers in response to various factors, including fees and performance. For example, in any given year between 1990 and 2008, between twenty-five percent and seventy percent of fund advisers experienced net outflows in total across all the funds that they advised. *Fact Book* 14. As a result, fund advisers feel intense

pressure to offer funds with performance, services, and fees that meet investors' needs.

Other studies confirm that investors respond to fund fees. A recent study found that, controlling for other relevant factors, a ten percent increase in fees decreases a fund's total net assets by as much as twenty-eight percent. Coates & Hubbard, *supra*, at 183. Another study found that "[p]rice competition is an effective way of obtaining market share" and that fund investors "do pay attention to price." *See, e.g.*, Khorana & Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry* 20 (July 2004) (last revised Mar. 22, 2009) (unpublished working paper) *available at* http://ssrn.com/abstract=240596.

To be sure, investors do not always choose the least costly mutual fund, nor necessarily even the least costly fund in a given category. Other factors may come into play, such as superior after-fee returns, various fund features (*e.g.*, different minimum initial investment requirements), services offered by the fund and its adviser, and the investor's relationship with a financial adviser—all of which can produce a dispersion of fees across funds, even though the market is keenly competitive.

C. The Competitive Mutual Fund Marketplace Benefits Investors By Giving Them A Wide Choice Of Funds At Low Cost

1. Investors benefit from choices

Petitioners and their *amici* describe the mutual fund marketplace as bereft of benefits to investors. That characterization is unfounded. Over the last forty years, mutual funds have greatly expanded the range of investments they offer investors. For example, in 1970

there were just 361 mutual funds, the great majority of which were "large-cap" U.S. stock funds. *Fact Book* 112-114. By 2008, investors could choose from 8,022 different mutual funds with a broad variety of investment objectives, including large-, medium-, and small-cap funds, international stock and bond funds, funds that invest in technology companies or health-care companies, and others.

Competition among advisers to manage investors' dollars has also spurred the development of new types of funds beyond traditional stock and bond funds. Since 1970, fund advisers have introduced innovative products such as money market funds, index funds, municipal bond funds, tax-exempt money market funds, socially conscious funds, tax-managed funds, emerging markets funds, target-date funds, and exchange-traded funds. The emergence of these new products provides investors with more choices to better achieve their investment objectives and encourages all fund advisers to offer the best possible products at the lowest cost possible.

Changes in technology and the ways mutual funds are sold have made it increasingly easy for investors to pick and choose the funds that best meet their needs. Investors can, at little or even no cost, switch between mutual funds offered by different fund advisers through employer-sponsored retirement plans, financial advisers, and full-service and discount brokers.[17] They

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[17] Petitioners and their *amici* also contend that competition among mutual funds is constrained by investors' potential capital gains tax liabilities for redeeming fund shares. *See, e.g.*, Pet. Br. 42; Law Prof. Amicus Br. 22. The brief for the Law and Finance Amici explains (at 15-17) why such claims are greatly overstated.

can also purchase fund shares directly from fund sponsors.

Mutual funds also offer substantial benefits to 401(k) plan participants, including a wide variety of investment choices. For example, the average 401(k) plan now offers plan participants eighteen different investment options including mutual funds. *See* Profit Sharing/401k Council of America, *51st Annual Survey of Profit Sharing and 401(k) Plans Reflecting 2007 Plan Experience* 26 (2008). In addition, employers who sponsor 401(k) plans can and do include mutual funds with lower fees. *See* ICI, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2008*, at 12-13 (Aug. 2009).[18] Finally, investors who leave an employer generally have the option of rolling their 401(k) assets into an IRA in any fund or funds they choose.

2. Fund investors have benefited from a decades-long decline in the total cost of fund investing

Brisk competition among advisers for investors' business has supported a decades-long decline in the overall cost of investing in a mutual fund. For example, the total cost of investing in stock mutual funds fell from 2.32 percent in 1980 to 0.99 percent in 2008, a decline of nearly 60 percent (Figure 1). ICI, *Trends in the*

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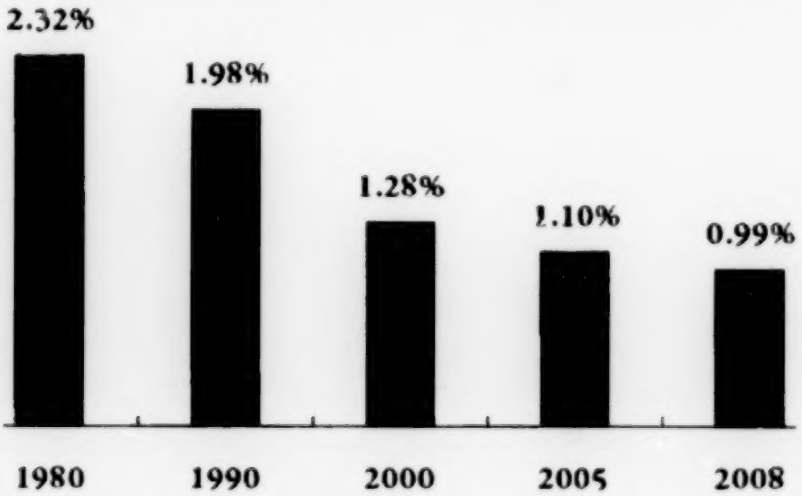
[18] Petitioners argue that 401(k) plans generally include "high-priced" funds, relying on a statement in a proposed Department of Labor (DOL) rule that 401(k) participants pay fees that are 11.3 basis points "higher than necessary." *See* Pet Br. 42 & n.30. In adopting the final rule, however the DOL expressly retracted that conclusion. *See Investment Advice—Participants and Beneficiaries*, 74 Fed. Reg. 3822, 3840 (Jan. 21, 2009) (the estimate "lacks adequate basis and should be disregarded").

Fees and Expenses of Mutual Funds, 2008, at 2 (Apr. 2009).[19] For bond mutual funds, the total cost of investing fell from 2.05 percent to 0.75 percent over the same period, a decline of 63 percent. *Id.*

Figure 1: Total Cost of Investing in a Stock Fund Has Declined By Nearly Sixty Percent Since 1980
(paid by investors as a percent of fund assets)



Source: Investment Company Institute

This sharp decline occurred despite a huge increase in the demand for mutual funds. In 1980, just 4.6 million households invested in mutual funds. By 2008, that figure had increased to 52.5 million households. With each household typically opening several mutual fund accounts, the number of accounts that mutual funds managed rose from 12.1 million in 1980 to 264.5 million

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[19] According to some studies, the fees paid by U.S. mutual fund investors are now among the lowest in the world. *See, e.g.*, Rekenthaler et al., *Global Fund Investor Experience* 13 (Morningstar Fund Research May 2009) (U.S. equity fund fees lowest of 16 countries studied).

in 2008. Basic economics suggest that all else equal, such a massive increase in demand normally should have led to an increase in fees. Fees instead declined as existing and new advisers offered more funds and as these advisers competed by seeking out and passing through cost savings, evidence that competition prevails in the fund industry.

In addition, as investors increasingly turned to mutual funds as their investment vehicle of choice, they demanded a greater array of services, and fund advisers competed to offer these services. For example, web-based and around-the-clock toll-free telephone access to fund information was virtually unheard of twenty years ago, but is commonplace today. *See* ICI, *Competition in the Mutual Fund Business* 4 (Jan. 2006). Although the cost of these additional services puts implicit upward pressure on total fund fees, investors in fact paid less. Stiff competition led advisers to provide enhanced services more efficiently and reduce fund expenses in order to attract investors.

CONCLUSION

The Court should reject petitioners' effort to replace *Gartenberg's* flexible approach with a simplistic comparison of the fees an adviser receives from a mutual fund with those received from its non-mutual fund institutional clients. Instead, the Court should conclude that *Gartenberg* articulates the appropriate standard for assessing claims under Section 36(b). Under that standard, the district court properly granted summary judgment to respondent. Accordingly, the judgment of the court of appeals should be affirmed.

Respectfully submitted.

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SEPTEMBER 2009

AMICUS CURIAE BRIEF

(24)

No. 08-586

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF LAW AND FINANCE *AMICI CURIAE* IN SUPPORT OF RESPONDENT

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INTEREST OF THE *AMICI CURIAE*[1]

Amici are law and finance professors and scholars, whose fields of academic inquiry include securities regulation, business organization, investment company law, and economics, a former Commissioner of the Securities and Exchange Commission ("SEC"), and a former general counsel of the SEC. *Amici* submit this brief to respond to Petitioners' brief and the *amici* briefs submitted in support thereof. In particular, *Amici* address misperceptions regarding competition in the mutual fund industry today and review current facts about the industry that demonstrate that competition for investors is an important force that constrains mutual fund advisory fees.

The *Amici*, listed alphabetically, are:[2]

William J. Baumol, Academic Director, Berkley Center for Entrepreneurial Studies, and Professor of Economics, New York University Stern School of Business.

Michael H. Bradley, Professor of Law, Duke University School of Law, and F.M. Kirby Professor of

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[1] No counsel for a party authored this brief in whole or in part, and no such counsel or party made a monetary contribution intended to fund the preparation or submission of this brief. No person other than *Amici* or their counsel made a monetary contribution intended to fund its preparation or submission. The parties have consented to the filing of this brief. The Petitioners have filed a blanket waiver and the Respondent's consent is being lodged herewith.

[2] *Amici* participate solely as individuals and not on behalf of the institutions or entities with which they are affiliated.

Investment Banking, Duke University Fuqua School of Business.

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Robert C. Clark, Harvard University Distinguished Service Professor and Austin Wakeman Scott Professor of Law, Harvard Law School.

John C. Coates IV, John F. Cogan, Jr. Professor of Law and Economics, Harvard Law School.[3]

Allen Ferrell, Greenfield Professor of Securities Law, Harvard Law School.

Joseph A. Grundfest, William A. Franke Professor of Law and Business, Stanford Law School, and Co-Director of the Arthur and Toni Rembe Rock Center on Corporate Governance, also a former Commissioner of the SEC.

Ehud Kamar, Professor of Law, University of Southern California Gould School of Law.

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[3] Professor Coates and R. Glenn Hubbard (Dean and the Russell L. Carson Professor of Finance and Economics, Columbia University Graduate School of Business, and Professor of Economics, Columbia University) co-authored the article *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. CORP. L. 151 (2007) ("Coates and Hubbard"). Both the Seventh Circuit panel opinion, and the dissent from denial of rehearing *en banc*, cited the article. *See* Pet. App. 12a (panel opinion) and Pet. App. 36a (dissent).

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Edmund W. Kitch, Mary and Daniel Loughran Professor of Law, University of Virginia School of Law.

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Simon M. Lorne, Vice Chairman and Chief Legal Officer of Millennium Management LLC (a hedge fund) and Co-Director of Stanford Law School's Director's College, also former SEC General Counsel.

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Larry E. Ribstein, Mildred Van Voorhis Jones Chair, University of Illinois College of Law.

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Roman L. Weil, V. Duane Rath Professor Emeritus of Accounting, University of Chicago Booth School of Business, and Board Member, MainStay Group of Funds.

This brief reflects the consensus view of *Amici*, each of whom believes that the decision below should be affirmed and, in so doing, this Court should adopt a standard that permits proper consideration of evidence of competition as a constraint on advisory fees under Section 36(b) of the Investment Company Act of 1940 (the "ICA"), 15 U.S.C. §80a-36(b).

SUMMARY OF ARGUMENT

Allegations that a mutual fund adviser charged a fund excessive fees are properly assessed in the context of the economic forces that affect these fees. Competition for mutual fund investors generally constrains advisory fees. The assertion that mutual fund boards rarely dismiss an adviser does not mean that fees are immune from fee competition. Rather,

the structure of mutual funds allows investors to react easily to fee disparities by investing elsewhere. Undisputed evidence shows that, as a general matter, consumer mobility in the mutual fund market exceeds that in many other markets, where significant transaction costs and other impediments restrain consumers from easily switching among different producers or products. Investor mobility, combined with other indisputable mutual fund industry characteristics, such as lack of concentration, a multitude of investor choices, low barriers to entry, common and continuous actual new entry, numerous distribution models, frequent and widespread advisory fee reductions, and, most importantly, strong and consistent correlations between lower advisory fees and higher returns, higher returns and investor flows, and lower fees and higher market share, results in robust fee competition.[4]

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[4] Petitioners disagree with this fundamental thesis and seek to buttress their disagreement with an attack on the objectivity of the Coates and Hubbard article cited by the court below. *See* Pet. Br. at 49; *see also supra* n.3. To be clear, the attack says nothing about the evidence on which the article relies—indeed, that evidence is consistent with a wealth of other scholarly analysis cited in this brief.

The claim that the article should be disregarded as "funded in part by the mutual-fund industry and co-authored by an expert witness in §36(b) cases" under *Exxon Shipping Co. v. Baker*, 128 S. Ct. 2605, 2626 n.17 (2008) ("declin[ing] to rely on" research "funded in part by" party to the case), is equally without merit. Pet. Br. at 49 and n.48. No party to this case contributed to the funding of the Coates and Hubbard article and Professor Coates, a professor at Harvard Law School, received no compensation in connection with the preparation of the article or this brief. Professor Hubbard, the Dean of Columbia Business

In evaluating whether, under Section 36(b) of the ICA, an advisory fee is so excessive as to be deemed a breach of "fiduciary duty with respect to the receipt of compensation for services," courts should consider, first, what are the fees charged by advisers of similar funds, and, second, does competition among similarly situated funds affect the advisory fees? Fees charged by competing advisors to similar funds will generally be more probative of advisory fees' fairness than other measures. It may be that in some contexts, evidence of competition will be absent or weak, but in many cases, it will be clear and strong. To interpret the ICA so as to ban evidence of competition between fund advisers—or to place lesser weight on such competition—would blind courts to an important set of facts relevant to the Section 36(b) analysis.

Gartenberg v. Merrill Lynch Asset Mgmt., Inc. appropriately recognized that courts should consider "all pertinent facts" when evaluating mutual fund advisory fees under Section 36(b). 694 F.2d 923, 929

School and a highly regarded academic, has, it is true, qualified and testified as an expert witness in Section 36(b) litigation. Such expert testimony, however, is not a reason to disregard the views set forth in either an academic article or in an *amicus* brief. Indeed, if it were, certain studies and articles relied on in the Brief of *Amici Curiae* Law Professors in Support of Petitioners would have to be disregarded as their authors have qualified as expert witnesses in Section 36(b) litigation. In fact, three such authors—Mercer E. Bullard (*see* Law Professors Am. Br. at 23), Lyman Johnson (*see* Law Professors Am. Br. at 3, 4), and Tamar Frankel (*see* Law Professors Am. Br. at 6, 23)—were proffered as experts *in this case*. *See, e.g.*, Def. Harris Associates L.P.'s Mot. to Exclude the Expert Testimony of Mercer Bullard, Tamar Frankel, Lyman Johnson and James Lamb.

(2d Cir. 1982). However, in *dicta* the *Gartenberg* court expressed skepticism regarding the existence of competition among funds and its impact on advisory fees. That court focused primarily on competition for a fund's advisory contract and noted funds rarely "fire" their advisers. In fact, courts should focus at the investor level. Investors, the economic evidence demonstrates, are fee sensitive. Advisers are aware of investor preferences and competition for investors constrains fees.

Therefore, this Court should clarify that the *dicta* in *Gartenberg* concerning the lack of competitive forces affecting advisory fees in the mutual fund industry are outdated and not binding. In particular, this Court should specify that courts should be permitted to consider two sets of facts relating to competition and advisory fees under Section 36(b): (1) evidence of competition for investors by funds similar to the type of fund at issue; and (2) evidence of the extent to which such competition constrains the fees charged by the adviser and approved by the fund's directors, and whether that competition is likely to produce fees similar to those generated by arm's-length bargaining.

ARGUMENT

I. EVALUTION OF ADVISORY FEES REQUIRES CONSIDERATION OF ALL PERTINENT FACTS

Section 15(c) of the ICA imposes on the independent directors of a mutual fund the duty "to request and evaluate" all "such information as may reasonably be necessary to evaluate" an advisory

contract. 15 U.S.C. 80a-15(c). Subsequent judicial review, occasioned by a suit under Section 36(b), similarly requires the Court to consider whether the directors' approval of the contract reflects a permissible business judgment under current market conditions; the directors' determination "shall be given such consideration by the court as is deemed appropriate under all the circumstances." Section 36(b)(2).

For the past twenty-five years, independent directors, in the first instance, and courts reviewing decisions of independent directors thereafter, have, overwhelmingly, evaluated advisory fees under the standard set forth by the Second Circuit in *Gartenberg*. The *Gartenberg* court held that to violate Section 36(b), "the Adviser-manager must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been a product of arm's length bargaining." 694 F.2d at 928. "To make this determination", the court stressed, "*all* pertinent facts must be weighed," including "the price charged by other similar advisers to funds managed by them," the "adviser-manager's cost in providing the service, the nature and quality of the service, the extent to which the adviser-manager realizes economies of scale as the fund grows larger, and the volume of orders which must be processed by the manager." *Id.* at 929, 930 (emphasis added). The court relied on the legislative history of Section 36(b) which "makes clear that Congress 'intended that the court look at all the facts in connection with the determination and receipt of such compensation.' . . ." *Id.* at 930 (quoting S. REP. NO. 91-184, at 15 (1969)).

Although specifically requiring consideration of "all pertinent factors," and agreeing that rates charged

by other advisers to similar funds were "a factor to be taken into account," *Gartenberg* criticized the lower court ruling that competitive fees were "the *principal* factor to be considered in evaluating a fee's fairness." *Id.* at 929 (emphasis added). The court offered two reasons: first, mutual funds have an "unseverable relationship" with their advisers that "tends to weaken the weight to be given to rates charged by advisers of other similar funds" and, second, "[t]he fund customer's shares of the advisory fee is usually too small a factor to lead him to invest in one fund rather than in another or to monitor adviser-manager's fees." *Id.*

In support of these points, the *Gartenberg* court relied on a report issued by the SEC in 1966 and quoted the report's conclusion that "'[c]ost reductions in the form of lower advisory fees . . . do not figure significantly in the battle for investor favor.'" *Id.* (quoting H.R. REP. NO. 89-2337, at 126 (1966) ("1966 SEC Report")).[5] *Gartenberg* further quoted from the

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[5] The 1966 SEC Report adopted conclusions from a study of the mutual fund industry conducted for the SEC by the Wharton School of Finance and Commerce in 1962. *See* 1966 SEC Report at 12. The Wharton report concluded that even though mutual fund assets grew in the 1950s, fees remained constant, meaning that (alleged) economies of scale were not being passed on to investors. *See A Study of Mutual Funds*, H.R. REP. NO. 87-2274, at 28-29 (1962) (the "Wharton Report"). According to that study, competition had "not been substantially operative in fixing the advisory fee rates paid by mutual funds" (*id.* at 494) because of the failure to pass on savings from economies of scale, and because advisers did not compete for retail mutual fund contracts (*see id.* at 493-94). A few years following the 1966 SEC Report, the Senate issued a report which largely

1966 SEC Report as follows: "negotiations between the unaffiliated [fund] directors and fund advisers over advisory fees would lack an essential element of arm's length bargaining—the freedom to terminate the negotiations and to bargain with other parties for the same services." *Id.* at 929 n.2 (citing 1966 SEC Report at 131). On this basis, *Gartenberg* stated that "fund[s] cannot move easily from one adviser-manager to another," because "'investment advisers seldom, if ever, compete with each other for advisory contracts with mutual funds.'" *Id.* at 929 (quoting 1966 SEC Report at 126).

These *dicta* have resulted in some courts (and possibly some independent directors) minimizing evidence of competition in the mutual fund industry or downplaying the effect of competition on fees in cases challenging advisory fees as excessive under Section 36(b). For example, in *Schuyt v. Rowe Price Prime Reserve Fund, Inc.*, the court gave "little weight" to expert testimony regarding "competition in the market for advisory services" because it was "directly contradicted by the views of the Second Circuit in *Gartenberg*." 663 F. Supp. 962, 974 (S.D.N.Y. 1987). In *Krinsk v. Fund Asset Mgmt., Inc.*, the court considered comparable fees, but did so saying that "such comparisons have limited value due to the lack of competition among advisers for fund business." 715 F. Supp. 472, 497 (S.D.N.Y. 1988) (citing *Gartenberg*, 694 F.2d at 929).

For the reasons set forth below, however, the economic evidence relating to the industry today demonstrates that the observations in the 1966 SEC

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tracked the conclusions in the Wharton Report and in the 1966 SEC Report. *See* S. REP. NO. 91-184, at 5-6.

Report, even if true when made, do not accurately characterize the industry today. Today, the robust competitiveness of the mutual fund industry constrains the amount of advisory fees that a fund adviser can charge.

> Adviser fees are based on fund assets, which in turn depend on competition among funds for investors. Any attempt by an adviser to use either excess fees or fund assets to subsidize the marketing of shares (and increase assets and fees) at the expense of performance is self-limiting and can only work over the short term. As a result of the relationship between fees and returns, competition among funds for investors necessarily affects advisers when they propose their fees, and affects the bargaining process between advisers and fund directors. Both advisers and fund directors are constrained by the effects of competition for fund investors.

Coates and Hubbard at 212. Although Petitioners and others purport to challenge these facts, none disputes the evidence summarized below demonstrating competition in the fund industry. Instead, they make conclusory statements or point to other, unrelated evidence that, on inspection, is consistent with competition constraining mutual fund advisory fees. Accordingly, the statutory scheme, and the evidence about competition in the mutual fund industry discussed below, demonstrate that consideration of competitive fees is relevant to the evaluation performed by independent directors, in the first instance, and by a court, in the event of a fee challenge.

II. COMPETITION FOR INVESTORS IS AN IMPORTANT FORCE THAT CONSTRAINS MUTUAL FUND ADVISORY FEES

Critics' skepticism about competition in the mutual fund industry dates back to the 1960s view that market forces fail to constrain advisory fees in part because the structure of mutual funds is such that fund boards rarely "fire" advisers or put advisory contracts out for bid.[6] However, as discussed below, investors can discipline a fund's adviser both by investing new cash flows in other funds or by redeeming their shares and re-investing elsewhere. This investor mobility, combined with other characteristics of the mutual fund industry—a lack of concentration, a multitude of investor choices, low barriers to entry and common and continuous actual entry, numerous distribution models, advisory fee reductions and declining historical advisory fee and expense trends, a correlation between lower advisory fees and higher returns, and investor sensitivity to fee changes—results in robust competition that constrains the amount of fees charged by an adviser.

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[6] *See* Pet. Br. at 26 ("Congress found that 'the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy,' because 'a mutual fund cannot, as a practical matter[,] sever its relationship with the adviser.'") (citations omitted); Law Professors Am. Br. at 5 ("The structure of mutual funds is notoriously 'incestuous,' with 'each fund a captive' to the investment advisor who forms, incubates, and rules it.") (citations omitted).

A. *Mutual Fund Industry Criticisms: Stuck in the 1960s*

The 1960s view reflected in the Wharton Report, and in the 1966 SEC Report cited in *Gartenberg*, is based on perceived conflicts of interest between investment advisers and mutual funds and their boards. Central to this alleged conflict is that mutual fund boards of directors rarely "fire" advisers. *See, e.g.*, AARP Am. Br. at 15 ("[I]ndividual investors in mutual funds lack collective bargaining power to lower investment fees because mutual fund directors are captives of their investment advisors."); NASCAT Am. Br. at 7 ("firing rights" as to the funds adviser "are virtually never exercised") (citing John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 J. CORP. L. 609, 617 (2001)).

These criticisms wrongly focus on the adviser rather than the investor and ignore both important structural features of mutual funds and the evolution of the mutual fund industry since the 1960s. It is the mobility of the customer that constrains fees. In terms of structure, investors have contractual rights (supplemented by SEC regulations) to "fire" advisers, redeeming their shares and investing their assets elsewhere. This constraint follows from a defining feature of "open end" mutual funds: investors have the ability to redeem their shares on a daily basis at current net asset value. *See* Victoria E. Schonfeld & Thomas M.J. Kerwin, *Organization of a Mutual Fund*, 49 BUS. LAW. 107, 112 (1993). This feature directly enables competition among advisers.

Moreover, mutual fund advisers—compensated, virtually without exception, based on a percentage of

assets under management ("AUM")—have a strong economic incentive to retain existing and attract new investors. Positive fund returns directly increase AUM, and indirectly increase AUM by drawing in new investors. Returns are measured after deducting fees, so fees have a direct impact on an adviser's reported returns. Because shareholders enjoy mobility, competition prevails as advisers seek high returns (net of fees) to attract investors. Thus, whatever the fund's board's ability to "fire" advisers, shareholders can and readily do "fire" advisers by moving to another fund.

Further, the mutual fund industry has changed significantly since the mid-1960s. Over the past forty years, the industry has grown markedly: in June 1966, 379 mutual funds held assets of $38.2 billion,[7] while at the end of 2008, over 8000 mutual funds held assets of $9.6 trillion.[8] Over the same period, there has been a marked trend towards not charging a "front end," or initial, fee at the time an investor buys shares in a fund: in June 1966, load funds accounted for nearly 95% of mutual fund assets;[9] as of 2006, no-load funds accounted for a majority of mutual fund assets.[10] In addition, the mutual fund distribution process is more open and promotes easier movement between funds and fund complexes than was true in the 1960s. *See infra* at 25-26.

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[7] 1966 SEC Report at 44.

[8] INV. CO. INST., 2009 INV. CO. FACT BOOK: A REVIEW OF TRENDS AND ACTIVITY IN THE INV. CO. INDUS. at 110 (49th ed. 2009) ("ICI Fact Book").

[9] 1966 SEC Report at 52.

[10] Coates and Hubbard at 157 and n.23.

Despite these significant changes to the mutual fund industry, Petitioners and their *amici* rely on an outdated assessment of competition and urge an interpretation of Section 36(b) based on that outdated understanding.[11] Such reliance and the proposed interpretation should be rejected because, as discussed below, the undisputed evidence demonstrates that competition for investors is an important force that constrains advisory fees.

B. *Investors Have a Ready Ability to Exit Funds and Do Exit Funds When They Disapprove of the Amount of Advisory Fees*

Consistent with the above theoretical analysis, direct evidence of investors switching mutual funds illustrates that investors are not locked into their funds or advisers. Indeed, significant amounts of switching occurs annually by fund investors. For example, during market downturns average annual rates of shareholder redemptions in equity funds (as a percentage of average net assets) have ranged from approximately 35% (2008), to 23% (2005), to 41% (2002), to 73% (1987). *See* ICI Fact Book at 137.

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[11] *See, e.g.*, Pet. Br. at 5 (Investment advisers "'seldom, if ever, compete with each other for advisory contracts with mutual funds'") (quoting 1966 SEC Report at 126); Law Professors Am. Br. at 6 ("[T]he forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.") (citing S. REP. NO. 91-184, at 5); *Id.* at 25 ("[T]he unique operational structure of mutual funds prevents sophisticated investors from creating a competitive pressure in mutual funds."); United States Am. Br. at 26 (whether advisory fees are subject to "competitive pressure" remains "the subject of lively debate.").

Where do these redeeming investors put their money? The data show that equity funds with below-median operating expense ratios have an overwhelming, and increasing, collective market share—83% in 1995 to 87% in 2005. *See* Brian Reid, *Competition In The Mutual Fund Business*, RESEARCH COMMENTARY (Inv. Co. Inst., Washington, D.C.), Jan. 2006, at 5, *available at* http://conference.ici.org/pdf/rc_competition.pdf. This evidence demonstrates that switching costs are not an impediment to investors moving from one adviser to another: investors have a ready ability to exit funds and do exit when they disapprove of the amount of advisory fees.

Moreover, competition would still be a powerful force to constrain advisory fees even if switching costs did materially affect the ability of investors to exit (which they do not). New investments by investors in funds (*i.e.*, dollars not affected by alleged adverse consequences of switching from one fund to another) continue to grow exponentially. To illustrate, if every mutual fund dollar in 1980 had been locked into its 1980 fund and these funds had not otherwise attracted new investors, by 2004, the market share of the 1980 funds would have shrunk from 100% to less than 5% of the overall fund industry. *See* Coates and Hubbard at 200. Competition to attract these new dollars is another significant force upon advisers and complexes to maintain competitive fee levels.

Empirically, there is also a strong inverse relationship between fees and a fund's growth in asset size. *See id.* at 183. That is, "holding other factors constant, investors shift substantial amounts of assets out of high-fee funds and into low-fee funds." *Id.* at 180. One reason is that high fees reduce returns—and returns are the key factor in attracting new investors.

Looking at the period from 1998 through 2004, a 10% increase in fund fees, holding all else equal, decreases a fund's total assets by 23% to 28% and a complex's assets by 15% to 19%. *Id.* at 183. Other studies have similarly concluded. *See, e.g.*, Andrew Zhang, *Mutual Fund Expense Ratios in Market Equilibrium* at 24 (July 20, 2007) (unpublished working paper, *available at* http://ssrn.com/abstract=1010544) ("the mutual fund industry is expense ratio competitive in the growth and index fund sectors," which supports the conclusion that the "U.S. fund industry provides a near textbook example of a competitive market structure"); WILLIAM J. BAUMOL ET AL., THE ECONOMICS OF MUTUAL FUND MARKETS: COMPETITION VERSUS REGULATION 161, 164 (Karl Bruner & Paul W. MacAvoy eds., Kluwer Academic Publishers (1990)) (demonstrating that "a one percent rise in the relative fee charged by a fund adviser will lead to a more than proportionate loss in that fund's market share" and concluding that "it is a mistake to base regulatory and judicial decisions on the premise that [money market funds] are not effectively constrained by market forces in their selection of fees").

These findings ought not be surprising because mutual fund investors seek returns, a motive that causes them to flock to funds with the highest recent returns. Funds necessarily compete on fees when they compete on returns as returns are correlated with lower advisory fees. An adviser, therefore, cannot simply raise fees with impunity because these studies show investors are fee sensitive. Unless it provides a commensurate increase in value (whether by increasing performance or services provided), investors will punish an adviser's unwarranted fee increase by moving their dollars to a competitor that provides better value.

This evidence directly refutes claims by Petitioners and their *amici* that mutual fund investors "do not exit despite high fees" both because of restrictions on exit and because investors "have demonstrated little behavioral capacity to invest rationally." Law Professors Am. Br. at 22, 23. The evidence, described above, demonstrates that investors do exit when they disapprove of the amount of advisory fees.

Petitioners' *amici* also claim that mutual fund investors face transaction costs—such as redemption fees or new sales charges—that lock investors into their funds and advisers, undermining mobility that theoretically exists with redeemable shares. *Id.* at 22 ("If, as the evidence demonstrates, investors do not exit despite high fees . . . then advisors can make a great deal of money"). Yet the trend in the mutual fund industry has, overwhelmingly, been towards minimizing these transaction fees (other than as a penalty to prevent over-frequent market-timing redemptions). For example, from 2002 through 2007, over 72% of net new investments in long-term funds were made in no-load (no sales charge fee) funds (with the reminder divided between load funds and variable annuities). *See* ICI Fact Book at 26. Moreover, with regard to all types of switching costs, as with other goods and industries, even a small portion of price-sensitive investors can force the entire industry to price their products competitively. Advisers receive higher fees for each dollar of AUM in a share class, regardless of whether the dollar comes from a price-sensitive or price-insensitive investor. Therefore, even if the above constraints make exit prohibitively costly for *some*

investors, the marginal investor's ability to exit free from transaction costs keeps fees low for *all* investors.[12]

One perceived switching cost—taxes—is not likely to significantly undermine competition among mutual funds, for two reasons. *See, e.g.*, Pet. Br. at 42 ("If an individual has owned a particular fund for a sufficient length of time, selling her shares likely would trigger adverse tax consequences"). First, nearly half of all mutual fund assets in 2008 were held in tax-deferred accounts or tax-exempt funds and roughly 70% of all fund-investing households in 2008 owned a portion of their assets through tax-exempt vehicles (such as 401(k)s or IRAs). *See* ICI Fact Book at 23, 84. That these customers can exit free of tax costs holds down fees for those who would incur tax costs to leave.

Second, new investment flows—which, as noted above, represent a large share of all assets invested in mutual funds—do not trigger taxes. An adviser that attempted to keep fees high on the assumption that taxes would constrain investors from moving their investments elsewhere would soon find itself with a diminishing market share because new investments face no such constraints.

Petitioners' *amici* also highlight search costs—the cost to an investor of finding a superior fund and adviser—as a restriction on investor mobility. *See* Law Professors Am. Br. at 22. These critics, however, fail to acknowledge the wide array of tools and

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[12] *See* Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1405-06 (1983) ("A market can be in competitive equilibrium even though the ratio of comparison shoppers to all consumers is much less than one").

comparative information—available on home computers—that the market provides investors, including free sources such as Morningstar and the comparison tools offered by various mutual fund supermarkets, such as Fidelity and Charles Schwab.[13] *See* ICI Fact Book at 81-82 (in 2008, 91% of U.S. households owning mutual funds had internet access and 82% of such households used the internet for financial purposes).

Critics also claim that investors face impediments to exit if they lack access to alternative mutual funds. As evidence, they point to the alleged lack of choice available within some 401(k) plans. *See, e.g.*, Pet. Br. at 42 ("401(k) plans and similar investment vehicles often have a limited menu of investment choices that restrict the investor's options to high-priced funds."); *see also* Law Professors Am. Br. at 22 (one reason "investors do not exit despite high fees" results from "limited options in their 401(k) plans"). Yet 401(k) plans generally offer a wide and growing range of options to investors. *See* Jeffrey R. Brown & Scott J. Weisbenner, *401(k) Investment Options, Portfolio Choice and Retirement Wealth* at 4 (Dec. 2005) (working paper, *available at* http://www.nber.org/programs/ag/rrc/books&papers.html and follow link to "NB05-03") (finding that from 1993 through 2002, "the median number of funds offered as investment options

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[13] *See* Charles Schwab—"Mutual Funds", http://www.schwab.com (select "Investment Products" tab and follow link to "Mutual Funds") (last visited Sept. 2, 2009); Fidelity Investments—"Mutual Funds at Fidelity", http://www.fidelity.com (select "Investment Products" tab and follow link to "Mutual Funds") (last visited Sept. 2, 2009); Morningstar—"Funds", http://www.morningstar.com (select "Funds" tab) (last visited Sept. 2, 2009).

by 401(k) plans in our sample rose from 5 to 13").[14] Moreover, plan administrators (who have a fiduciary duty to the plan participants) select the funds for inclusion in each plan from among an even broader selection of available funds. In addition, the funds are offered as a part of a complex bundle of services that can include recordkeeping and advisory services, the prices for which are often negotiated by sophisticated retirement plan committees that often retain professional consultants to advise them in the negotiation of these arrangements. Finally, employers can respond to non-competitive fees and change plan providers, administrators, and options. Thus, again, competition plays a role.

Another alleged impediment to competition is alleged investor ignorance and irrationality in choosing funds due to cognitive biases.[15] Petitioners' *amici* also argue that investors are "unaware" of the fees their

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[14] In addition, 401(k) plans that offer self-directed brokerage windows offer investors an even broader range of options.

[15] *See, e.g.*, Pet. Br. at 43 ("most mutual-fund investors do not rationally process fee information"); Law Professors Am. Br. at 23 (Investors "have demonstrated little behavioral capacity to invest rationally"); *but see* Zoran Ivković & Scott J. Weisbenner, *"Old" Money Matters: The Sensitivity of Mutual Fund Redemption Decisions to Past Performance* at 4 (May 2006) (unpublished working paper, *available at* http://ssrn.com/abstract=903792) (determining that "psychological motivations . . . play much less of a role in the domain of individuals' mutual fund investments than they do in the domain of investment into individual stocks").

adviser charges.[16] Rational investors, however, need only gather information about fees when they deem it useful. For example, many investors rely on third-party fiduciaries (*e.g.*, employers or financial advisers) to provide information or even make choices on their behalf. Indeed, among investors owning mutual fund shares outside of retirement plans at work, 77% own fund shares through professional financial advisers. ICI Fact Book at 68. Additionally, as noted above (*see supra* at 18), only a subset of fund investors need to be price-aware and price-sensitive for advisers to have an incentive to set fees at the competitive level. Furthermore, differences in fees may reflect different levels of value investors place on fund services, rather than irrationality.

C. *The Mutual Fund Industry Offers a Multitude of Choices to Investors, Barriers to Entry Are Low, and New Entry Is Common*

To capitalize on their ability to redeem their shares, investors need feasible alternatives: to "fire" an adviser is an empty threat unless the investment can relatively easily be put to better use. The mutual fund industry presents a wide range of fund choices, low barriers to entry, and common and continuous actual

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[16] *See* John C. Bogle Am. Br. at 30 ("[F]unds do not generally compete on the basis of costs, and investors accordingly are generally unaware of how much they are paying in costs or the enormous effects that such costs can have on performance over long periods of time."); *see also* Litan et al. Am. Br. at 8 ("The vast majority of investors cannot accurately assess the quality of the mutual funds in which they invest."); *id.* at 13 ("[T]he vast majority of mutual fund investors lack essential information necessary for them to make informed decisions.").

new entry. Consequently, large shifts in market share occur.

More than 8000 mutual funds affiliated with hundreds of fund complexes (*i.e.*, funds with a common adviser) compete for investors' dollars.[17] ICI Fact Book at 12, 66. These mutual funds present a wide array of investment choices with varied risk tolerance, different services and liquidity, and diverse sectors and geographies. This wealth of options, coupled with investor mobility, means that funds and advisers can keep their investors and attract new ones only by delivering consistent value. Choice drives competition. To illustrate, over the last twenty-five years the number of equity mutual funds and complexes has increased, while the concentration of investments in those funds has declined over that same period, a clear indication that no fund or complex has a dominant market share. *See* Coates and Hubbard at 165 (Table 1).[18]

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[17] *See* Sunil Wahal & Albert (Yan) Wang, *Competition Among Mutual Funds* at 23-24 (Nov. 2008) (unpublished working paper, *available at* http://ssrn.com/abstract =1130822) (concluding that established funds that face competition from new fund entrants are "more likely to use fee waivers, use larger fee waivers and experience lower flows").

[18] The Vanguard Group's growth to one of the largest fund complexes in the U.S.—based in large part on price competition—is not consistent with the outdated 1960s view that there is no effective advisory fee competition in the mutual fund industry. *See* Coates and Hubbard at 167. Notably, the Managing Director of the Vanguard Group has acknowledged that price competition exists in the industry and Vanguard's Founder has attributed Vanguard's success to its minimized costs. *See Improving*

In addition, exchange-traded funds (ETFs), open-end mutual funds traded on an exchange, offer a rival vehicle to investors for investing in diversified stock portfolios. These ETFs exert competitive pressure on mutual funds and their fees. ETFs invest in groups of stocks designed to replicate the performance of market indices or particular sectors. Although ETFs do not issue redeemable shares to retail investors, they provide comparable liquidity because their owner can sell ETF units on the secondary market or back to the ETFs in exchange for the asset's underlying securities. They thus generally compete directly with indexed mutual funds. *See id.* at 164 n.57. ETFs have grown rapidly in recent years, from total net assets of approximately $16 billion in 1998 to $531 billion at the end of 2008. *See* ICI Fact Book at 40, 41.

Low barriers to entry into the mutual fund industry also contribute to competitive advisory fees. The costs are relatively low, both in time and money, for a fund complex to add an additional fund or for a new adviser to enter the market.[12] Funds and

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Price Competition for Mutual Funds and Bonds: Hearing Before the Subcomm. on Fin. and Hazardous Materials of the H. Comm. on Commerce, 105th Cong. 69-75 (1998) (statement of F. William McNabb III, Managing Dir., Vanguard Group); *Mutual Fund Industry Practices and Their Effect on Individual Investors: Hearing Before the Subcomm. on Capital Markets, Insurance, and Government Sponsored Enterprises of the H. Comm. on Financial Services*, 108th Cong. 74 (2003) (statement of John C. Bogle, Founder, Vanguard Group) ("Bogle Statement").

[12] *See generally Improving Price Competition for Mutual Funds and Bonds: Hearing Before the Subcomm. on Fin. and Hazardous Materials of the H. Comm. on Commerce*, 105th Cong. (1998) (statement of Matthew P. Fink, President,

complexes entering the mutual fund industry since 1990 have secured billions of dollars in new investments. Indeed, the top equity mutual fund complexes in 2004 that did not exist in 1994 were larger than approximately 70% of existing complexes; and the top new fund entrants in that same time period were larger than 95% of existing funds. *See* Coates and Hubbard at 167-68. In addition, an analysis of the distribution of mutual funds by complex size evidences competitiveness—complexes in various sizes from 6 to 100 funds increased the number of funds offered from 1985 to 2004. *Id.* at 168-69.

Competition in mutual fund distribution also aids investors. Currently, investors can purchase shares through numerous channels, including: (1) direct sales, (2) retirement plans, (3) full-service financial firms, (4) fund supermarkets and discount brokers, and (5) annuity plans offered by insurance companies. Moreover, mutual funds offer multiple share classes, which present a range of price choices to investors targeted, in part, to the potential length of their investments. *See, e.g.*, ICI Fact Book at 27 (discussing share classes).

One market innovation noted above—fund supermarkets—has especially added to investors'

Inv. Co. Inst.); 3 TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS: MUTUAL FUNDS AND ADVISERS § 21.04[A] (2d ed. 2009) (acknowledging that only $100,000 in capital is required by SEC regulations to start a fund); Laurin Blumenthal Kleiman & Carla G. Teodoro, *Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations*, *in* THE ABCS OF MUTUAL FUNDS 11, 57–58 (Practicing Law Institute 2006) (stating that a fund can be created within three months).

convenience. *See generally* Martine Costello, *One-Stop Fund Shopping*, CNNMoney, Mar. 6, 2000, http://money.cnn.com/2000/03/06/mutualfunds/q_funds_supermarket. Run by brokerage firms, fund supermarkets provide investors the ability to select from a large number of mutual funds and fund families and transfer assets between such fund families with relative ease, often within one brokerage account. With multiple fund families available from a single source, investors can more easily compare funds' fees, operating costs, and historical fund performance and ratings. Rather than filing paperwork with, keeping track of, and interacting with multiple fund complexes, supermarkets provide investors with a mechanism to manage their investments at a one-stop shop. This permits, in effect, investors to form their own "complexes" of funds, selecting funds from various mutual fund families.[20]

As a result of the competitive nature of the mutual fund industry, advisers' market shares significantly fluctuate. As the Table below shows, some complexes' market shares rose dramatically (*e.g.*, Vanguard's market share almost doubled from 6.36% in 1985 to 12.63% in 2004) while others lost much of their market

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[20] One example of the popularity of supermarkets is reflected in the asset growth of Charles Schwab's Marketplace fund supermarket: from $31 billion in 1994 to $333.9 billion at the end of 2008. CHARLES SCHWAB & CO., 1999 ANNUAL REPORT (1999) at 35, *available at* http://www.aboutschwab.com/annualreport99/financialreview/gis.pdf; CHARLES SCHWAB & CO., 2008 ANNUAL REPORT (2008) at 9, *available at* http://www.aboutschwab.com/media/pdf/2008annual_report_fullprint.pdf.

share (*e.g.*, American Express's share dropped from 3.72% to 1.07% over the same time period).[21]

Shares Of Equity Assets Under Management Of Top 25 Mutual Fund Complexes, 1985-2004			
Complex	**1985**	**1995**	**2004**
AIM Investments	1.17%	3.50%	1.56%
AllianceBernstein	1.35%	*0.72%*	0.93%
American Century	2.11%	2.43%	1.65%
American Express	3.72%	2.10%	1.07%
American Funds	7.76%	9.48%	14.09%
Citigroup Ast Mgmt	1.97%	1.42%	1.05%
Columbia Mgmt Adv	*0.99%*	1.28%	0.93%
DFA	--	*0.30%*	0.89%
Davis-Selected Adv	*0.25%*	*0.25%*	0.87%
Delaware	1.03%	*0.39%*	*0.27%*
Dodge & Cox	*0.05%*	*0.24%*	1.62%
Dreyfus	3.23%	0.96%	0.94%
Eaton Vance	1.33%	*0.19%*	*0.61%*

[21] The data in this Table come from Table 7 in Coates and Hubbard (at 179) (noting "[s]hares of equity assets under management are measured as of year-end. Complexes with italicized values for a given year are not in the top 25 in that year.") (citing Strategic Insight (Simfund) (The Strategic Insight Simfund is a current and comprehensive historical database of over 32,000 U.S.-based open and closed mutual funds, fund-of-funds and exchange-traded funds (ETFs). Simfund contains thousands of data fields and fund details, including assets, cash flows, volatility, portfolio statistics, sales loads, detailed expenses, advisory fee breakpoints, service providers and official performance data, rankings and ratings from all major third party sources. *See* Strategic Insight—"Simfund: Mutual Fund Database", http://www.sionline.com/aboutsi/about_simmf.asp (last visited Sept. 2, 2009)).

Evergreen Investmt	1.87%	0.97%	*0.65%*
Fidelity	10.42%	18.56%	14.05%
Franklin Templeton	4.85%	4.20%	3.74%
Grantham Mayo	*0.02%*	0.79%	0.76%
Ivy Invst Mgmt	1.95%	0.86%	*0.47%*
JPMorgan Funds	*0.04%*	*0.75%*	0.85%
Janus	*0.36%*	1.74%	1.66%
Lord Abbett	2.41%	*0.46%*	0.88%
MFS	2.81%	1.14%	1.46%
Merrill Lynch	2.28%	3.15%	1.11%
Morgan Stanley Adv	1.25%	2.09%	*0.70%*
OppenheimerFunds	2.41%	1.35%	1.77%
Phoenix Investment	*0.84%*	0.83%	*0.15%*
Pioneer	3.41%	0.99%	*0.46%*
Prudential Finl	*0.85%*	1.15%	*0.56%*
Putnam	4.27%	3.43%	2.13%
Scudder	2.49%	2.11%	0.93%
Seligman	1.13%	*0.47%*	*0.17%*
T Rowe Price	3.17%	2.54%	2.72%
Van Kampen	3.36%	*0.73%*	1.23%
Vanguard	6.36%	7.70%	12.63%
Wells Fargo Bank	*0.45%*	0.96%	*0.73%*

As Coates and Hubbard note, these "changes in market share are a direct reflection of competition, with more successful funds growing at the expense of rivals." Coates and Hubbard at 178.

D. *Advisers Compete on the Basis of Advisory Fees*

Petitioners' *amici* tout a study, performed by the U.S. General Accounting Office in 2000, that concluded that "competition in the mutual fund industry may not be strongly influencing fee levels" because advisers generally do not compete "on the basis of the fees they

charge."[22] Yet the GAO Report found that "fund advisers generally compete on the basis of performance." GAO Report at 7. Performance, typically measured by percentage annual return on investment, necessarily reflects fees (returns equal share appreciation less fees).

Moreover, the GAO Report's conclusions contradict each other for two reasons. First, shareholders invest their funds to reap the highest return on their investments, a calculation that factors in, among other things, performance, services provided, and convenience. A rational shareholder would not focus on fees independent of a fund's performance. Second, many studies show a strong positive association between a fund's returns and the size of the fund. Because fees are factored into returns, the logic of the GAO Report that mutual funds compete on returns but not on fees is flawed. Competing on returns necessarily involves competing on fees.

As a result of fee competition, mutual funds with relatively low fees experience large in-flows of assets. For example, one study of the relation between total fund expenses (including advisory fees, sales charges

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[22] General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* at 7 (June 2000), *available at* http://www.gao.gov/archive/2000/gg00126.pdf ("GAO Report") (cited in Law Professors Am. Br. at 20 n.21); *see also* AARP Am. Br. at 14 ("[E]vidence suggests that mutual fund 'managers do not compete on costs.'") (citing John C. Bogle, Lecture, *A New Order of Things: Bringing Mutuality to the "Mutual" Fund*, 43 WAKE FOREST L. REV. 1089, 1113-14 (2008)); *id.* at 15 ("[F]ees are higher than they would be if investment advisers were forced to compete on the basis of price.").

charged at the time of purchase, and marketing and distribution fees) and fund complex market shares from 1979 to 1998 (for open-end fund complexes) found a strong inverse relation between expenses and market share: the lower the expenses, the higher the complex's market share. Ajay Khorana & Henri Servaes, *Conflicts of Interest and Competition in the Mutual Fund Industry* at 20 (July 2004) (unpublished working paper, *available at* http://ssrn.com/abstract=240596). The study's authors concluded that "[p]rice competition is an effective way of obtaining market share." *Id.* These results persisted even after the authors adjusted for the fact that larger funds may charge lower fees due to economies of scale. *Id.*

Another study found that funds with lower expense ratios experienced the greatest asset growth. Vikram Nanda et al., *Family Values and the Star Phenomenon: Strategies of Mutual Fund Families*, 17 REV. FIN. STUD. 667, 680 (2004). That study suggests that a 10% decline in expenses increases new fund flow by 2.5%. *Id.*

Price reductions also highlight the competitive forces at work in the mutual fund industry. Advisers use one type of price reduction, fee waivers (temporary reductions that are not directly reflected in advisory contract amendments), to improve results for funds that would otherwise have relatively poor performance. In this way, an adviser can compensate for lower share appreciation by charging lower fees and thus improving overall returns to investors. The Table below shows that from 1998 through 2004, over 40% of equity share classes waived fees each year.[23]

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[23] The data in this Table come from Table 5 in Coates and Hubbard (at 174) (noting, *inter alia* that "[a] share class

Fee Waivers For Equity Mutual Fund Share Classes, 1998-2004		
Year	Number of Share Classes	Percentage of Share Classes With Fee Waivers
1998	1,995	42.0%
1999	2,325	46.9%
2000	2,699	41.7%
2001	3,543	45.7%
2002	4,168	49.2%
2003	4,341	48.4%
2004	4,139	48.0%

If the 1960s view of the absence of competition for advisory fees were true, such fee waivers would not occur.

With regard to one type of mutual fund, money market funds, evidence of competition in the form of price reductions is even more stark. Money market funds, which compete largely on returns due to their relatively standardized objectives, offer substantial fee reductions and waivers. In fact, a 2001 study found that 55% of retail money market fund managers waived almost two-thirds of their contracted-for fees. Susan E.K. Christoffersen, *Why Do Money Fund Managers Voluntarily Waive Their Fees?*, 56 J. FIN. 1117, 1121 (2001). This is because "[d]ifferences in

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is determined to have waived fees if the average gross expense ratio inclusive of reimbursements and waivers, weighted by assets in each share class, exceeds the actual average expense ratio paid by shareholders") (citing Strategic Insight (Simfund)).

money market fund net returns are determined almost entirely by differences in expenses borne by shareholders, with the lowest-fee money market funds having the highest net returns." Coates and Hubbard at 173 (citing Bogle Statement at 75).

Critics also characterize trends in fees and expense ratios in the mutual fund industry as proof of advisers taking excessive fees. *See, e.g.*, Bogle Statement at 72. They further allege that because fees have allegedly risen since the 1950s, advisers have been reaping the benefits of economies of scale at the expense of investors. This claim is flawed. First, studies of trends in average expense ratios do not consistently report increasing fees.[24] Second, the SEC concluded that the primary cause of increasing average expense ratios was that firms shifted from sales charges, which are not included in expense ratios, to marketing and distribution fees (*i.e.*, Rule 12b-1 fees), which are part of expense ratios and have been rising over time. *See* Coates and Hubbard at 176. Drawing conclusions about price competition in mutual funds based on trends in expense ratios will mislead unless one accounts for, among other things, the type and timing of sales charges, changes over time in the composition of funds, and changes in distribution channels. *Id.*

Still, critics say, if the mutual fund industry is truly competitive, why do supposed features of non-competitive markets persist? One example of alleged non-competitive behavior Petitioners and their *amici* posit is that advisory fees among similar funds are

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[24] *See* Coates and Hubbard at 175 and Table 6 (finding that the studies report conflicting results, depending on the time period analyzed (results are mixed within long and short time periods), how expense ratios are measured, and the sample of funds analyzed.

widely dispersed. Critics are especially concerned with alleged price dispersions among passive funds, such as S&P index funds, which invest in essentially identical portfolios. *See, e.g.*, John C. Bogle Am. Br. at 28 n. 10 ("[P]erhaps the most striking results [of the Freeman & Brown study] were provided by the S&P index funds, which in fact require very little investment advice.").

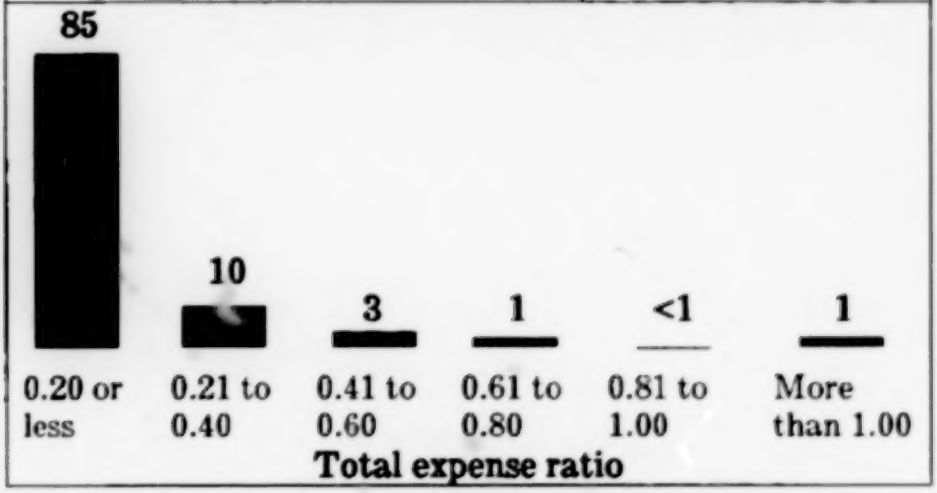
Two fallacies belie concerns about price dispersion. First, mutual fund advisers offer different business models and services to investors. Some choose to compete for investors by offering extensive services, incurring higher costs and charging correspondingly higher prices, while others choose to compete with fewer services, lower overhead and lower prices. *See* Coates and Hubbard at 167. In addition, some funds have requirements that explain lower fees, such as minimum investment requirements or constraints on liquidity. *See id.* at 196. Therefore, seller differentiation helps explain price dispersion (even among passive funds). The important determinant for investors, like customers of most other goods and services, is value—not simply price.

Second, because investors generally hold more than one fund, focusing on price comparisons between individual funds will not take into account benefits of investing within one fund family. *See, e.g.*, ICI Fact Book at 73 (the median number of funds held by an investor is four). Many investors favor the convenience of investing with one firm instead of in many funds among several firms; therefore, they focus on the bundled price of all their funds rather than the fees associated with a single fund. As a result, complexes compete by offering the best overall value, but need not necessarily offer the best value for each fund.

As reflected in the Figure below, at the end of 2008, 95% of investments in the S&P 500 index sector were concentrated in funds with the lowest expense ratios (less than forty basis points).[25]

Investor Assets Were Concentrated in S&P 500 Index Mutual Funds With The Lowest Expense Ratios

Percentage of Total Assets of S&P 500 Index Mutual Funds, Year-End 2008



Note: Percentages do not add to 100% due to rounding.
Sources: Investment Company Institute and Lipper.

Those invested in other S&P 500 index funds with higher expense ratios, however, are not being cheated by their advisers. Instead, they likely enjoy many benefits—no search costs to find a new firm and fund, the convenience of having their investments

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[25] The data in this Figure come from Figure 5.6 of the ICI Fact Book (at 66) (citing Investment Company Institute and Lipper); *see also* Coates and Hubbard at 195 Figure 3 (in 1990 and 2004, more than 90% of investments in the S&P 500 index sector were concentrated in funds with the lowest expense ratios, below 0.5%).

centralized in one complex, knowledge of the firm's operations, the ability to inexpensively alter asset allocations by shifting investments from fund to fund—to investing in an S&P 500 index fund that may have marginally higher fees. *See* Coates and Hubbard at 197. This is not inconsistent with competition among complexes based on price: "price dispersion reflects search costs for some investors, as well as different levels of service, particularly at the complex level, and different liquidity and trading costs. Buyer choice is the hallmark of competitive markets." *Id.*

CONCLUSION

As set forth above, contrary to outdated criticisms, numerous facts demonstrate that competition for investors is an important force in the mutual fund industry that constrains advisory fees. In articulating the legal standard applicable to an assessment of whether mutual fund advisory fees are excessive under Section 36(b) of the ICA, this Court should specify that two sets of facts relating to competition and advisory fees should be considered: (1) evidence of competition for investors by funds similar to the type of fund at issue; and (2) evidence of the extent to which such competition constrains the fees charged by the adviser and approved by the fund's directors, and whether that competition is likely to produce fees similar to those generated by arm's-length bargaining. This important information should inform the decisions of independent directors, evaluating advisory fees in the first instance, and of courts in the event of a fee challenge.

For the foregoing reasons and the reasons in the brief of Respondent, *Amici* respectfully urge this Court to affirm the judgment of the Seventh Circuit.

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AMICUS CURIAE BRIEF

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(11)

SUPREME COURT, U.S.
FILED
OCT 19 2009
OFFICE OF THE CLERK

No. 08-586

IN THE
Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Petitioners,

v.

HARRIS ASSOCIATES L.P.,
Respondent.

On a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

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INTEREST OF *AMICI CURIAE*[1]

Amici are scholars[2] at American law schools whose research and teaching interests focus on federal securities regulation, business organizations, and the law of investment funds. *Amici* have no financial stake in the outcome of this case but are interested in ensuring a uniform and coherent interpretation of the Investment Company Act of 1940. We file this brief to urge this Court to clarify the proper scope of the fiduciary duty that investment advisors owe to fund shareholders with respect to the compensation that advisors receive. We are prompted to submit this brief because the decision in this case will have wide-ranging consequences for millions of American investors and the trillions of dollars they entrust to these fiduciaries.

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[1] No counsel for any party has authored this brief in whole or in part, and no person or entity other than *amici curiae* has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. Counsel for Petitioners filed a letter with the Clerk granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of Respondent to the filing of this brief has been filed with the Clerk. *See id.*

[2] A full list of *amici*, who join this brief as individuals and not as representatives of any institutions with which they are affiliated, is set forth in the Appendix to this brief.

SUMMARY OF ARGUMENT

Even in a time of historic financial disruption and ferment, this case presents a remarkably opportune question regarding the extent to which federal courts "may, or indeed must, defer to market forces."[3]

In enacting the Investment Company Act of 1940 (the "Company Act"), Congress constructed a *sui generis* regulatory regime to govern a system of saving, which has grown to ninety-three million U.S. shareholders of mutual funds and ten trillion dollars of assets, and to protect investors and investments from the fees that advisors charge, which now surpass one hundred billion dollars each year.[4] Concluding that mutual funds are riven with structural conflicts of interest and uncommonly impoverished in protective market forces, Congress in 1970 armored investors with the additional aegis of judicial review by statutorily imposing "a fiduciary duty upon advisors with respect to the receipt of compensation for services." 15 U.S.C. § 80a-35(b). To determine whether the fees an advisor charges violate this Section 36(b) duty, this Court should apply a fiduciary standard with modest scope but forceful effect to counterbalance the structural and behavioral vulnerabilities preventing market forces alone from imposing competitive discipline upon advisory fees.

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[3] William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. Ill. L. Rev. (forthcoming), *online at* http://ssrn.com/abstract=1412878.

[4] *See* Investment Company Institute, *2009 Fact Book* 7 (49th ed. 2009), *online at* http://www.icifactbook.org; John C. Bogle, *Enough: True Measures of Money, Business, and Life* 44 (2008) ("In 2007, the direct costs of the mutual fund system (largely management fees and operating and marketing expenses) totaled more than $100 billion.").

The ruling below profoundly errs by embracing an approach that reduces the Section 36(b) fiduciary duty to a practical nullity while endorsing the validity of fees generated in a mutual fund market distinctly bereft of competitive market forces. *Jones v. Harris Assocs. L.P.*, 527 F.3d 627 (7th Cir. 2008). With its imaginative economic reinterpretation of Section 36(b), the Seventh Circuit elided a critical provision of the statute; ignored the purposes of the legislation so clearly enunciated by Congress in Section 1(b) of the Company Act, which commands that the act's language be interpreted to favor "the interests of investors" over industry; and retreated from the notably uniform and consistent legislative history elucidating this fiduciary duty.

The court below initiated its argument first by unmooring itself from the appellate precedent governing this field for the past quarter-century, *Gartenberg v. Merrill Lynch Asset Management, Inc.*, 694 F.2d 923 (2d Cir. 1982). In *Gartenberg*, the Second Circuit defined Congress's "fiduciary duty" language through an overlapping troika of standards – one substantive, one procedural, and one multivariate – which have been misread and distorted by subsequent rulings to demand an exaggerated showing of outlandish compensation to trigger a violation. The *Gartenberg* court may have gone too far in requiring not just largeness or unreasonableness in a fee but what Professor Lyman Johnson characterizes as even greater "extremeness"[5]: the advisor "must charge a fee that is *so disproportionately large* that it *bears no reasonable relationship* to the services rendered *and*

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[5] Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 Vand. L. Rev. 497, 516 (2008).

could not have been the product of arm's-length bargaining." *Gartenberg*, 694 F.2d at 930 (emphases added). Nevertheless, the *Gartenberg* court did enumerate a menu of factors that could, if applied faithfully, demonstrate the excessiveness or unreasonableness of a fee. *See id.* at 929-930. Inasmuch as no plaintiff has ever prevailed under any litigation purporting to interpret these standards in more than a quarter-century,[6] however, either no advisor has breached its fiduciary duty during that time or, as Johnson concludes instead, "something is amiss under Section 36(b)."[7]

Last year in the case below, the Seventh Circuit contracted the Section 36(b) fiduciary standard even further. Expressly disavowing the doctrinally convoluted and substantively weak duty that has evolved in Section 36(b) litigation over the past twenty-five years, the court in *Jones* concocted a doctrinally simple but substantively impotent variation. Rather than seeking guidance from enlightening mutual fund or corporate precedent, the court relied instead on a meager reading of the law of trusts to reach the conclusion that the Section 36(b) duty requires only that a "fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Jones*, 527 F.3d at 632. Thus, the Seventh Circuit's new standard reduces Section 36(b) to merely a generic anti-fraud entreaty, providing no substantive limit on fees and duplicating the pre-existing regulatory regime that already required advisors to behave themselves.

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[6] *See* James D. Cox et al., *Securities Regulation: Cases and Materials* 1211 (3d ed. 2001).

[7] Johnson, *supra* note 5, at 519.

In the ruling below, the court of appeals undervalued the need for a meaningful fiduciary duty because – notwithstanding congressional conclusions to the contrary – it overvalued the efficacy of market forces in disciplining mutual fund advisory fees. But as Judge Richard Posner noted when dissenting from the Seventh Circuit's denial of rehearing en banc in *Jones*, the economic analysis propping up such jurisprudence is lamentably "one-sided" and "ripe for reexamination." *Jones v. Harris Assocs. L.P.*, 537 F.3d 728, 733, 730 (7th Cir. 2008) (Posner, J., dissenting from denial of rehearing en banc). With the dramatic failure of large and sophisticated sectors of the U.S. and global economies, neither mutual fund trustees nor federal courts can reasonably continue to indulge such a credulous vision of romanticized market forces while ignoring the congressionally enacted fiduciary duty designed expressly to safeguard shareholders who "stand in special need of legal protection" from the demonstrated vulnerability of such forces. S. Rep. No. 91-184, at 3 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4899.

The structure of mutual funds is notoriously "incestuous," with "each fund a captive"[8] to the investment advisor who forms, incubates, and rules it.[9] Upon creating a fund, an advisor then sustains its new client on "life support" by externally providing the fund's entire management.[10] An important step in this dependent relationship is the advisor's appointment of all the fund's trustees, whose earliest

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[8] *Gartenberg*, 694 F.2d at 927, 929.

[9] *See* Paul G. Mahoney, *Manager-Investor Conflicts in Mutual Funds*, 18 J. Econ. Persp. 161, 163-164 (2004).

[10] William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 Tul. L. Rev. 1401, 1423-1424 (2006).

duties include blessing the size of the advisor's compensation.[11] Indeed, when enacting Section 36(b), Congress noted that "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." *Id.* at 5, *reprinted in* 1970 U.S.C.C.A.N. 4901. Moreover, when considering the Company Act previously, this Court has twice examined the legislative history to descry Congress's "concern with the potential for abuse inherent in the structure of investment companies." *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (quoting *Burks v. Lasker*, 441 U.S. 471, 480 (1979)) (internal quotation marks omitted).

In typical corporations, whose governance is policed by a wide array of market mechanisms absent from mutual funds,[12] the decisions of boards of directors on issues such as managerial compensation are often afforded judicial deference through the business judgment rule.[13] *See, e.g., Kamen v. Kemper Fin. Servs., Inc.*, 500 U.S. 90, 101 (1991) (citing *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 & n.10 (Del. 1981)). That rule, however, has no application and courts do not abstain when conflicts of interest exist.[14] Taking particular note of the "unique struc-

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[11] *See generally* 2 Tamar Frankel & Ann Taylor Schwing, *The Regulation of Money Managers* § 12 (2d ed. 2001).

[12] *See* Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 Wash. U. L.Q. 1017, 1032-1036 (2005).

[13] For a vigorous critique of compensation in corporations, see Lucian Bebchuk & Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (2004).

[14] *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 Nw. U. L. Rev.

ture of mutual funds" – and, more importantly, "the potential conflicts of interest" inherent in their structure – Congress refused to adopt a similar rule of judicial abstention in the context of mutual funds. S. Rep. No. 91-184, at 2, *reprinted in* 1970 U.S.C.C.A.N. 4898. On the contrary, the imposition of the Section 36(b) fiduciary duty was a deliberate attempt to devise "an effective means for the *courts* to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." *Id.* (emphasis added). Although the numbers of funds, advisors, and investments in this industry have changed since the enactment of Section 36(b), the structure of the mutual fund industry – which is what troubled Congress – remains unchanged to this day.

As the Eighth Circuit has very recently held, in the nation's first ruling in favor of a mutual fund shareholder in over thirty years of Section 36(b) litigation, the impact of these economic infirmities can readily be observed when a court considers the actual operations of funds. *See Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816, 819 (8th Cir. 2009). In *Gallus*, the court emphasized the troubling disparity between the high fees the advisor charged its retail shareholders and the low fees it charged "institutional, non-fiduciary clients" for "essentially the same" services and concluded that an inquiry into that discrepancy was critical "to determine what the investment advice is worth." *Id.* at 824. Most importantly, the court in *Gallus* demonstrated that, when reasonably expanded and applied, the *Gartenberg* standards are sufficiently broad to compass additional

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547, 603 (2003) ("The business judgment rule . . . has no application where the board of directors is disabled by conflicted interests.").

ways "in which a fund adviser can breach its fiduciary duty." *Id.* at 823.

The fiduciary test in *Jones* effectively invalidates the duty that Congress enacted in Section 36(b) by placing faith in an unsupported and anachronistic economic interpretation of mutual funds. Specifically, the decision below undermines an act of Congress by ruling that investors must seek their protection from governance and competition, not from a fiduciary duty. But the overwhelming preponderance of academic studies continues to find economic and behavioral constraints inherent in the structure of mutual funds and to validate Congress's refusal to abandon shareholders to the vicissitudes of a flawed market. This Court should develop a more effective fiduciary duty – one that actually implements the statutory language promulgated in Section 36(b) – by endorsing the more sophisticated and robust economic analysis undergirding the opinions of Judge Posner and the Eighth Circuit.

ARGUMENT

I. THE SECTION 36(b) FIDUCIARY DUTY POSSESSES MEANINGFUL INDEPENDENT FORCE

In *Jones*, the court of appeals failed to acknowledge that the Section 36(b) fiduciary duty possesses any meaningful force. Shareholders have never prevailed in practice under cases misapplying *Gartenberg*; they cannot prevail even in theory under *Jones* without either proving the violation of some other, preexisting prohibition against fraud or demonstrating impossibly gross distortions in the advisor's compensation. In the absence of fraud, the court below found it "possible to imagine compensation so unusual that a court will infer that deceit must have occurred"

only in circumstances equivalent to an advisor charging the cartoonish fee of more than fifty percent – or five thousand basis points – of assets under management. *Jones*, 527 F.3d at 632.[15]

In essence, these rulings perpetuate the status quo ante legislation and thus judicially void Section 36(b)'s purpose and puissance. By imparting content to the statutory standard, this Court will give meaning to Congress's clear command that an advisor's compensation is guided by a fiduciary duty. For guidance as to that content, this Court should consider Section 36(b)'s text and structure, the legislative reports that accompanied the statute's enactment, and the corresponding duties elaborated in the analogous doctrinal field of corporate law.

A. The Structure and Content of the Company Act Substantiate the Fiduciary Duty's Independent Force

By declining to define "fiduciary duty" in Section 36(b), Section 2, or elsewhere in the Company Act, Congress ceded to the federal courts the duty of imbuing this concept with operational meaning. When adding this new provision in 1970, Congress did not, however, fail to provide useful guidance as to the broader fiduciary standard imposed by Section 36(b). Indeed, Congress furnished a text of full legal force together with a template for its explication.

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[15] The Seventh Circuit's example involved a university paying its president "$50 million a year" when such an amount constitutes a twenty-five fold increase over the next-highest salary. *Gartenberg*, 527 F.3d at 632. Given that several advisors currently charge fees greater than two percent of assets, an equivalent "violation" in the mutual fund setting would require a fee greater than fifty percent, which is so fantastic as to be impossible.

First and foremost, the very language of Section 36(b) includes a critical clause that distinguishes this fiduciary duty from any preexisting or generic legal obligation. This duty applies specifically to "the receipt of compensation for services." 15 U.S.C. § 80a-35(b). The use of this language clearly modifies the Section 36(b) duty to require an advisor to vouchsafe good faith, fair dealing, and other trappings of a fiduciary expressly in conjunction with the fees it charges. The court below *completely elides this critical provision of the statute*, effectively reading pivotal language out of its analysis. To conclude that this provision means only that a "fiduciary must make full disclosure and play no tricks," as the Seventh Circuit did, renders the fiduciary duty impotent and otiose in a regulatory regime already bristling with antifraud provisions. Indeed, this Court has previously concluded that surplusage cannot be the fate of this duty, noting instead that "Section 36(b) creates an entirely new right." *Daily Income Fund*, 464 U.S. at 541.

At the time of Section 36(b)'s enactment, investment advisors were specifically obliged to make full disclosure and to play no tricks by Section 34(b) of the Company Act, 15 U.S.C. § 80a-33(b) (making unlawful any untrue statements of material fact in a registration statement or other documents); Section 206 of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6 (making unlawful any fraud upon clients or prospective clients); Sections 11, 12, and 17 of the Securities Act of 1933, 15 U.S.C. §§ 77k, 77*l*, 77q (imposing civil liability for false registration statements and for noncompliant prospectuses, and making unlawful any fraudulent interstate transactions); and Section 10(b) of the Securities Exchange

Act of 1934, 15 U.S.C. § 78j(b), and Exchange Act Rule 10b-5, 17 C.F.R. § 240.10b-5 (making unlawful the use of any manipulative or deceptive devices). The obvious implication and effect of adding the Section 36(b) duty to this regime was to create a distinct and new legislative duty specifically promulgated to obligate advisors to behave as fiduciaries in connection with the compensation that they can charge and receive.

Second, Section 1 of the Company Act clearly declares the policy animating this legislation and unequivocally asserts the manner in which the law should be interpreted. 15 U.S.C. § 80a-1. Under the heading of policy, the act enumerates occasions on which the "national public interest" is "adversely affected," including "when investment companies are organized, operated, [or] managed . . . in the interest of directors, officers, [or] investment advisers . . . rather than in the interest of all classes of such companies' security holders." *Id.* § 80a-1(b). To remedy this situation, the statute provides the following statement of purpose and guidebook to explication:

> It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the *interest of investors*.

Id. (emphasis added). In setting forth this controlling interpretive rubric, Congress clearly expressed its solicitude for investors over industry in competing claims of welfare, such as in the debate concerning excessive compensation. Surprisingly, Section 1 of the Company Act is not even mentioned in *Jones*.

Notwithstanding the clear text and this interpretive guidance, the ruling below gives no weight to Congress's decision to move advisors beyond their minimal requirements of providing disclosure and avoiding trickery.

B. The Legislative History Provides Consistent and Cumulative Support for a Robust Fiduciary Duty That Is Judicially Enforceable

Contrary to the assertions of the courts in *Gartenberg* and *Jones*, the legislative history accompanying the enactment of Section 36(b) is not "tortuous," *Gartenberg*, 694 F.2d at 928, nor does it "contain[] expressions that seem to support every possible position," *Jones*, 527 F.3d at 633. This Court has twice delved deeply and comfortably into this legislative history without expressing frustration at indeterminacy. *See Daily Income Fund*, 464 U.S. at 535-541 ("In evaluating such a claim, our focus must be on the intent of Congress when it enacted the statute in question."); *Burks*, 441 U.S. at 480-481. In this case, the supporting legislative record is remarkably uniform in its repeated critique of the structure of the mutual fund industry and emphatic in its repeated demand for a meaningful standard that the judiciary can enforce. *See generally* S. Rep. No. 91-184, *reprinted in* 1970 U.S.C.C.A.N. 4897.

Only in one brief passage does the Senate Report discuss the fact that a provision in an earlier version of the bill stating that "management fees should be 'reasonable'" was ultimately replaced with the creation of a "fiduciary duty." *Id.* at 5-6, *reprinted in* 1970 U.S.C.C.A.N. 4902. But nothing suggests that a fiduciary standard permits any lesser conduct by advisors. In the Report's own words, the fiduciary

duty is simply "a different method of testing management compensation," though notably one accompanied by "the traditional function of the courts to enforce such fiduciary duties in similar type relationships." *Id.*

More importantly, the Report is unambiguous in rejecting an extreme standard that would require a "showing of 'corporate waste'" or a fee that "[s]hock[s] the conscience of the court." *Id.* at 5, *reprinted in* 1970 U.S.C.C.A.N. 4901. While "[s]uch a rule may not be an improper one when the protections of arm's-length bargaining are present," it is "unduly restrictive" in "the mutual fund industry where[] these marketplace forces are not likely to operate as effectively." *Id.* Yet the standard set forth in *Jones* is equivalent to corporate waste and conscience-shocking tests, inasmuch as no plaintiff has ever prevailed under Section 36(b) and apparently cannot do so without identifying fees so grotesque as to shock the laws of economics.

Although the determination of compensation in the standard business organization is often insulated from judicial review by the business judgment rule, *see, e.g.*, *Kamen*, 500 U.S. at 101, Congress chose a different approach for mutual funds. Judicial abstention is not appropriate – even under the business judgment rule[16] – when conflicts exist. Based on its conclusion that conflicts are an indelible and inherent feature of the architecture of mutual funds, Congress therefore decreed that judicial abstention is never warranted here. *See* S. Rep. No. 91-184, at 2, *reprinted in* 1970 U.S.C.C.A.N. 4898. Repeatedly and without contradiction, the Report forcefully calls

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[16] *See, e.g.*, Bainbridge, *supra* note 14, at 603.

upon the federal courts to establish and then to police the contours of this fiduciary duty.

The Senate Report consistently demonstrates Congress's preference for courts to supplement market forces, adopting "the basic principle that, in view of the potential conflicts of interest involved in the setting of these fees, there should be effective means for the courts to act where mutual fund shareholders or the SEC believe there has been a breach of fiduciary duty." *Id.* Furthermore, "[t]his bill . . . provides an effective method whereby the courts can determine whether there has been a breach of this duty by the adviser or by certain other persons with respect to their compensation from the fund." *Id.* In addition, "the Congress recognized that investment companies and those who entrust their savings to such companies stand in special need of legal protection." *Id.* at 3, *reprinted in* 1970 U.S.C.C.A.N. 4899. Finally, Section 36(b) "authorize[s] the court to determine whether the investment adviser has committed a breach of fiduciary duty in determining or receiving the fee." *Id.* at 6, *reprinted in* 1970 U.S.C.C.A.N. 4902. This cumulative and uncontroverted legislative history is inimical to the standard established in *Jones*, which explicitly rejects any participation of courts in standing sentinel at the perimeter of the Section 36(b) fiduciary duty.

C. Although Mutual Funds and Corporations Differ *Economically*, the *Law* of Corporations Is Analogous and Persuasive

Perhaps the central error of the Seventh Circuit's ruling in *Jones* is that it compares mutual funds overenthusiastically to corporations in its *economic* analysis but apathetically in its *legal* analysis. That is, the court insisted that mutual funds and corpora-

tions are alike in competitive market dynamics when, in fact, they are not, *see infra* Part II.B; yet the court then applied to mutual funds a crabbed legal interpretation of corporate fiduciary principles. Inasmuch as Congress has imbued mutual funds with considerable statutory protections of their own, this Court should raise shareholders' fiduciary protections *at least* to the level actually enjoyed by corporate shareholders.

Rejecting guidance from legislation, legislative history, and the *Gartenberg* precedent regarding the meaning and content of the Section 36(b) fiduciary duty, the court below cast about for another source of illumination. *See Jones*, 527 F.3d at 632. The Seventh Circuit derived its conception of fiduciary duty from an impoverished reading of the law of trusts and corporations. *Id.* Repeatedly in *Jones*, the court invoked parallels from corporations in its musings upon the competitiveness of market forces affecting mutual funds. *See, e.g., id.* ("Things work the same for business corporations"); *id.* at 632-633 ("Publicly traded corporations use the same basic procedures as mutual funds"); *id.* at 634 (comparing shares in mutual funds to automobiles). With respect to competitive market dynamics, such comparisons are inapposite and misleading because they fail to acknowledge the critical structural and operational differences between the two different species of business entity.[17] With respect to judicial doctrine, however, a fair comparison would be highly appropriate given the analogous legal features and agency incentives governing participants in both systems.

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[17] *See* Langevoort, *supra* note 12, at 1031-1032.

The doctrine of fiduciary duties in corporations, read properly, is particularly robust when addressing instances of self-dealing similar to the conflicted compensation system of mutual funds. Indeed, the typically impenetrable business judgment rule that shields compensation and other managerial decisions must yield when conflicts exist. Inasmuch as conflicted self-dealing is built into the very structure and operation of mutual funds, the application of corporate – to say nothing of mutual fund – fiduciary principles would provide far greater protection in these circumstances than the Seventh Circuit offered. *See, e.g., Telxon Corp. v. Meyerson*, 802 A.2d 257, 264 (Del. 2002) (noting that the business judgment rule gives way to an entire fairness analysis in circumstances involving self-dealing); *Valeant Pharms. Int'l v. Jerney*, 921 A.2d 732, 748-749 (Del. Ch. 2007) (stating that, "where the pricing terms of a transaction that is the product of an unfair process cannot be justified by reference to reliable markets . . . , the burden of persuading the court of the fairness of the terms will be exceptionally difficult.").

In a broader trend, Delaware courts in recent years have generally enhanced the suite of corporate fiduciary duties. For instance, the duty of loyalty has recently incorporated a duty of good faith, with the consequence that corporate fiduciary duties now "expand the potential scope of director liability"[18] for inappropriate behavior. *See, e.g., Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 239-240 (Del. 2009); *DeSi-*

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[18] Andrew S. Gold, *The New Concept of Loyalty in Corporate Law*, 43 U.C. Davis L. Rev. at 6 (forthcoming 2009), *online at* http://ssrn.com/abstract=1406207 ("Recent precedents now suggest that unconflicted directors may be charged with disloyalty in cases where they are sincerely motivated to benefit shareholders and the corporation.").

mone v. Barrows, 924 A.2d 908, 933 (Del. Ch. 2007) (stating that directors may have violated their fiduciary duties when they have "consciously taken action beyond their authority" even if "their motives were not necessarily selfish"); *Stone ex rel. AmSouth Bancorp. v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (absorbing the fiduciary duty of good faith into the duty of loyalty). Commentators believe that, although this "incorporation of the duty of good faith into loyalty" has reduced the number of duties from three to two, it has nevertheless "significantly expanded the potential circumstances in which a successful loyalty claim might be brought."[19]

The Seventh Circuit fundamentally misapplied the applicable principles of corporate law, which impose robust fiduciary duties in circumstances such as these. Although the Section 36(b) duty may be new and distinctive in the Company Act, as this Court has noted in *Daily Income Fund*, 464 U.S. at 541, fiduciary duties have long been a venerable and vital concept in business organizations and they possess far more significance than the merely duplicative and generic antifraud provision set forth in *Jones*. With even a fraction of the force of analogous corporate duties, the Section 36(b) fiduciary conception would play a discrete but critical role in safeguarding mutual fund shareholders from the most egregious violations by their fiduciaries.

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[19] *E.g.*, *id.* at 14.

II. MARKET FORCES ALONE ARE INSUFFICIENTLY COMPETITIVE TO COMPENSATE FOR A NUGATORY FIDUCIARY DUTY OR TO IMPOSE DISCIPLINE ON MUTUAL FUND ADVISORY FEES

In the ruling below, the court of appeals failed to take seriously the need for a fiduciary duty with force because it took all too seriously the quaint and anachronistic claim – renounced by Congress – that self-correcting market forces by themselves effectively discipline advisory fees. Such a ruling implicitly requires a court to assume, in the absence of any statutory or historical evidence, that Congress intended the Section 36(b) fiduciary duty to seesaw in an inverse relationship with the level of market competition. Moreover, in order to apportion a minimal level of duty in such a dynamic system, a court would first need to conclude that truly competitive market forces do abound.

Yet, as Judge Posner and others have demonstrated, the economic analysis propping up such jurisprudence is "one-sided" and "ripe for reexamination." *Jones*, 537 F.3d at 733, 730. The recent financial crisis has taught the clear and painfully learned lesson that an uncritical embrace of panacean forces of rational actors and unsupervised markets is profoundly irresponsible. A closer and more sophisticated examination of the economic governance structures of mutual funds reveals a market suffering serious flaws whose shareholders do, indeed, "stand in special need of legal protection" from a meaningful fiduciary duty. S. Rep. No. 91-184, at 3, *reprinted in* 1970 U.S.C.C.A.N. 4899.

A. The Structure of Mutual Funds, Which Prompted Congress To Enact the Section 36(b) Fiduciary Duty, Remains Conflicted

In the ruling below, the Seventh Circuit pivoted from disparaging the need for a fiduciary duty to celebrating the salutary forces of competition via a dubious trio of arguments. In order to embrace market competition, the court first had to overcome legislative history that clearly criticized the "structure of the mutual-fund market at the time." *Jones*, 527 F.3d at 633. The court overran this obstacle by characterizing that legislative history as indeterminate (it "contain[s] expressions that seem to support every possible position"); then by dismissing all legislative history in favor of a supposedly textualist approach ("Congress did not enact its members' *beliefs*, it enacted a text."), albeit one in which it ignored the critical text; and finally by conducting a "living Constitution" analysis of the state of market competition ("A lot has happened in the last 38 years."). *Id.* As we have already presented the decidedly clear state of Section 36(b)'s legislative history[20] and do not aspire to debate the question of legislative history more generally, the only remaining claim to address concerns the state of competition today.

The Seventh Circuit's assertion that competition is now vibrant in mutual funds, whatever legislators may have thought four decades ago, is fallacious in several ways. First, the court's evidence for such an argument – which was not provided by the parties but assembled solely by the bench – relies on statistics regarding the *size* of the industry and not at all on changes in the *structure* of the industry. Nowhere

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[20] *See supra* Part I.B.

in the legislative history, or indeed the enacted text, does Congress bewail an insufficient number of funds, channels for investment, or assets under management, all of which the Seventh Circuit celebrated in 2008. *See id.* at 633-634. Rather, Congress enacted the Section 36(b) fiduciary duty because it feared the "structure" of the mutual fund industry, its "conflicts of interest," and the absence of "arm's-length bargaining." S. Rep. No. 91-184, at 5, *reprinted in* 1970 U.S.C.C.A.N. 4901. Growth in the number of mutual funds and advisors may be less a sign of health than a symptom of the infestation of commissions, trail payments, and revenue sharing arrangements that arrogate investors' 12b-1 fees to provide brokers and other intermediaries with an incentive to promote investments without regard for the underlying fees that shareholders must bear.[21] These structural and systemic faults remain unchanged to this day, and arguments regarding the size of the industry do nothing to ameliorate them.

B. The Economic Governance Structure of Mutual Funds Is Far Weaker Than That of Corporations

The court below also assumed that the market dynamics of mutual funds are healthy and competitive because they are equivalent to those of business corporations. *See, e.g., Jones*, 527 F.3d at 632 ("Things work the same for business corporations"); *id.* at 632-

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[21] *See, e.g.*, General Accounting Office, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* 7 (June 2000), *online at* http://www.gao.gov/archive/2000/gg00126.pdf (concluding that, notwithstanding the presence of thousands of mutual funds, "competition in the mutual fund industry may not be strongly influencing fee levels" because advisors do not compete "on the basis of the fees they charge").

633 ("Publicly traded corporations use the same basic procedures as mutual funds"); *id.* at 634 (comparing shares in mutual funds to automobiles). Even though the legal dynamics of both business entities are similar, the structural and operational differences between funds and corporations undermine facile economic comparisons.

The standard theoretical account of effective governance in corporations identifies and lauds the cooperative efforts of a panoply of mutually reinforcing mechanisms. The combined forces of efficient capital markets, stock options, markets for corporate control, short selling, and influential institutional investors, *inter alia*, are thought to impose a healthy discipline on agency costs between managers and shareholders.[22] Critically, the presence of such mechanisms – and therefore the force of such theory – is vastly diminished in mutual funds.

As Professor Donald Langevoort has pointed out, many of the most important of these devices simply do not exist or do not operate effectively within the idiosyncratic structure of mutual funds:

> Because mutual funds are not traded in an organized market, arbitrage opportunities cannot work to keep prices in line with rational expectations. Mutual fund prices are simply the product of net asset value at the time of purchase or redemption. Insider compensation is largely based on assets as well, which creates the conflict rather than aligns insider-shareholder interests, and directors are typically paid all or mostly in cash. Institutional shareholder voice does not

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[22] *See, e.g.*, Jonathan R. Macey, *Corporate Governance: Promises Kept, Promises Broken* 50 (2008).

> exist in the fund area, and there is no external market for corporate control at all because shareholders can only sell their shares back to the fund.[23]

Accordingly, any judicial attempt to graft general economic governance theory onto mutual funds fundamentally misunderstands the distinctive nature of funds.

The solitary remaining governance constraint with any applicability in the mutual fund context is shareholder exit. As the court below correctly noted, "An adviser can't make money from its captive fund if high fees drive investors away." *Jones*, 527 F.3d at 632. Of course, as Judge Posner noted, the premise of this assertion is questionable: "That's true; but will high fees drive investors away?" *Jones*, 537 F.3d at 731. If, as the evidence demonstrates, investors do not exit despite high fees – because of limited options in their 401(k) plans, adverse tax consequences, search costs, redemption fees, or other limitations – then advisors can make a great deal of money.[24] Effective shareholder exit relies upon faithful disclosure by advisors and prudent investment by shareholders. In mutual funds, exit is handicapped by the

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[23] Langevoort, *supra* note 12, at 1031-1032.

[24] *See, e.g.*, Stephen Choi & Marcel Kahan, *The Market Penalty for Mutual Fund Scandals*, 87 B.U. L. Rev. 1021, 1023 (2007) ("But investors, for a variety of reasons, may fail to redeem shares in response to managerial wrong-doing. They may be unaware of any managerial wrong-doing . . . . They may (if the funds are not held in a tax-exempt account) face adverse tax consequences if they redeem shares in mutual funds. Investors may also have to pay a fee when shares are redeemed.").

proven vulnerabilities of both participants in this investment dyad.[25]

Investment advisors have spent much of the past five years reeling from regulatory investigations and private lawsuits into their malfeasant practices in the operation of mutual funds, such as late trading and failing to disclose market timing,[26] for which they have paid billions of dollars in fines, settlement fees, and restitution funds.[27] Meanwhile, investors, encumbered with ever-greater responsibility for their own retirement savings as 401(k) plans eclipse pension funds, have demonstrated little behavioral capacity to invest rationally: many investors fail to enroll in retirement plans, leave their contributions uninvested, or allocate their savings too rarely, riskily,

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[25] Informational intermediaries and investment brokers are of little help in facilitating these transactions. *See* Jill E. Fisch, *Fiduciary Duties & the Analyst Scandals*, 58 Ala. L. Rev. 1083, 1097-1098 (2007) (discussing the conflicts of interest and questionable independence of mutual fund analysts).

[26] *See generally, e.g.*, Birdthistle, *Compensating Power*, *supra* note 10; Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 Ann. Rev. Banking & Fin. L. 235 (2006); Mercer E. Bullard, *The Mutual Fund as a Firm: Frequent Trading, Fund Arbitrage and the SEC's Response to the Mutual Fund Scandal*, 42 Hous. L. Rev. 1271 (2006).

[27] Many of the best known investment advisors in the retirement savings industry have paid eight- and nine-figure settlements over the past five years, including, *inter alia*, Bank of America ($675 million), Alliance Capital Management ($600 million), and Bear Stearns ($250 million). *See, e.g.*, Josh Friedman, *FleetBoston, BofA to Pay $675 Million*, L.A. Times, Mar. 16, 2004, at C1; Tom Lauricella, *Alliance to Cut Fees 20%*, Wall St. J., Dec. 16, 2003, at C1.

or rapidly.[28] The Seventh Circuit's assumption that high fees will "drive investors away" thus ignores the enfeebled state of shareholder exit in mutual funds.

C. Market Forces Do Not Ensure Competitive Advisory Fees in Mutual Funds

The court below retreated to three final economic claims to prop up its overarching claim that market forces ensure competitive advisory fees in mutual funds. First, even if mutual fund shareholders are unsophisticated, the presence of sophisticated investors will protect them, *see Jones*, 527 F.3d at 634; second, the price for products such as automobiles receives no judicial review, so mutual fund advisory fees should not, either, *see id.*; and, third, a single academic study concluded that this market is competitive, *see id.* None of these claims survives serious examination.

First, the Seventh Circuit attempted to preempt critique of its conclusion that the mutual fund market is competitive by stating that

> [i]t won't do to reply that most investors are unsophisticated and don't compare prices. The sophisticated investors who do shop create a competitive pressure that protects the rest.

Id. But, as with the court's previous claim that advisors could not make money if high fees risked driving

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[28] *See, e.g.*, Alan R. Palmiter & Ahmed E. Taha, *Mutual Fund Investors: Divergent Profiles*, 2008 Colum. Bus. L. Rev. 934, 974-975 (citing scholarly demonstrations of deleterious investor behavior); James D. Cox & John W. Payne, *Mutual Fund Expense Disclosures: A Behavioral Perspective*, 83 Wash. U. L.Q. 907, 926-927 (2005) (same); Mahoney, *supra* note 9, at 168-172 (same); Richard H. Thaler & Cass R. Sunstein, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. Chi. L. Rev. 1159, 1169-1170 (2003) (same).

away investors, an argument that is theoretically debatable in the corporate context is simply inapplicable to mutual funds. Just as the unique governance structure of mutual funds prevents high fees from driving away investors, the unique operational structure of mutual funds prevents sophisticated investors from creating a competitive pressure in mutual funds. Empirical studies and, indeed, the industry's investment offerings and overt marketing demonstrate that investment advisors intentionally segregate institutional and individual investors into separate mutual fund products.[29] Investment advisors commonly offer different funds or different classes of shares with far more advantageous pricing to institutional and sophisticated shareholders.

Second, the Seventh Circuit compared mutual fund shareholders to the buyers of products and wondered why they should receive a different degree of judicial oversight:

> Judges would not dream of regulating the price of automobiles, which are produced by roughly a dozen large firms; why then should 8,000 mutual funds seem "too few" to put competitive pressure on advisory fees?

Id. This question reveals a fundamental conflation of the governance dynamics of mutual funds with an ordinary products market. The price of automobiles is not judicially actionable because the buyers of automobiles are neither shareholders nor the beneficiaries of a congressionally enacted fiduciary duty. Fully aware of these distinctions and cognizant of the

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[29] *See* Langevoort, *supra* note 12, at 1033 ("The theory does not work, however, if the market can be segmented with similar but different products, with inferior products being marketed to the less sophisticated.") (citing Mahoney, *supra* note 9, at 168-169).

particular vulnerabilities of mutual funds, Congress decreed investors in those funds to be both. Accordingly, Congress enacted the Company Act and Section 36(b) to rectify the disadvantaged situation of mutual fund shareholders by raising them as much as possible to a position similar to that of purchasers in competitive and unconflicted product markets. Congress may very reasonably have concluded that the manner in which investors save for their retirement is ultimately of far greater consequence than the price of any given widget. Absent a recategorization by Congress of mutual fund shareholders as mere purchasers and no longer the beneficiaries of a fiduciary duty, the judiciary must enforce legislation designed to protect them, not engage in reverse boot-strapping to undermine further their already-impoverished governance circumstances.

Third, in seeking support for its conclusion, the court found support from only one academic study. *See Jones*, 527 F.3d at 634 (citing John C. Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 Iowa J. Corp. L. 151 (2007)). The citation of this lone study is curious given its singular conclusion that competition has favorably impacted fees notwithstanding evidence that fees have risen as more entrants have appeared in the field.[30] Moreover, the overwhelming preponderance of careful scholarly studies report contrary conclusions, which the court either did not find or chose not to consider. *See, e.g.*, John P. Freeman, Stewart L. Brown & Steve Pomer-

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[30] *See, e.g.*, John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Test*, 61 Okla. L. Rev. 83, 106-122 (2008) (critiquing the Coates-Hubbard study).

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III. WITH A GREATER APPRECIATION FOR THE STRUCTURE AND OPERATION OF MUTUAL FUNDS, THIS COURT SHOULD EMPHASIZE COMPARISONS BETWEEN RETAIL AND INSTITUTIONAL FEES IN THE SECTION 36(b) FIDUCIARY DUTY

The key indicium of a lack of competitiveness in mutual funds is the material and systemic discrepancy between the fees that advisors charge ordinary retail shareholders in captive mutual funds and the fees that advisors charge institutional clients to whom they owe no fiduciary duty. Across mutual funds, retail investors pay fees twice the size of those paid by institutional clients – when those higher

rates are applied to the larger pools of assets in retail funds, advisors make six times as much money from ordinary investors for providing the same service.[31] Yet this discordant fact is the one piece of evidence that courts have omitted from their menus of salient factors, even though "the expressed Congressional intent" was that "all pertinent facts must be weighed." *Gartenberg*, 694 F.2d at 929, 931 & n.3.

None of the other *Gartenberg* factors alone or in concert provides so much probative value on the issue of fee excessiveness. Only by analyzing the lower rates paid by institutional funds, which enjoy a far less structurally intertwined and captive relationship with investment advisors, can a plaintiff demonstrate how far an advisor has strayed from its Section 36(b) obligations. This fee comparison – which is a "proxy for fairness" and uniquely free from "self-dealing"[32] – should lie at the heart of this Court's efforts to fashion a meaningful standard for the fiduciary duty.

Despite rejecting the illuminating comparison of fees that a single advisor charges its retail and institutional investors, the court below followed *Gartenberg* by permitting comparisons of fees that different advisors charge retail investors in separate mutual funds. *Jones*, 527 F.3d at 631 (citing *Gartenberg*, 694 F.2d at 929). Allowing a comparison only between advisors but not between investors is willfully myopic.

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[31] *See* Freeman & Brown, 26 J. Corp. L. at 631 (reporting an average fee of 56 basis points for retail investors and 28 basis points for institutional investors, notwithstanding the fact that the retail funds were three times as large as the institutional funds).

[32] Emily D. Johnson, *The Fiduciary Duty in Mutual Fund Excessive Fee Cases: Ripe for Reexamination*, 59 Duke L.J. at 36 (forthcoming 2009), *online at* http://ssrn.com/abstract=1382001.

As Judge Posner has pointed out, if the "governance structure that enables mutual fund advisers to charge exorbitant fees is industry-wide" – or even just sector-wide – then ignoring the relevant comparison between fees paid by different investors will effectively prevent any plaintiff from successfully claiming that a fee is excessive. *Jones*, 537 F.3d at 732.

The court in *Jones* nevertheless declined to examine the fee discrepancy between institutional and retail investors. Advisors have long complained that, because not all clients are perfectly identical, a comparison of their fees is fruitless. Of course, any court – or board of trustees – could ask the advisor to conduct the simple arithmetic to account for any additional costs to service the retail fund and then compare fees.

In the case below, the Seventh Circuit provided a non sequitur on this issue, pointing out that sophisticated investors pay more to invest in hedge funds than retail investors pay to invest in mutual funds. *Jones*, 527 F.3d at 634. That fact may very well be true, but fee comparisons are relevant only to the extent that they compare similar services. Hedge funds (which are not subject to Section 36(b)) and mutual funds are radically different investments with totally incompatible risk profiles. Institutional investors may pay more than retail investors pay for many things – office space, letterhead, automobiles – but the only relevant issue is the price the two types of investors pay when buying the same service.

Indeed, institutional investors do not pay more than retail investors for identical investment services from advisors. When institutional investors invest in separate accounts that are clones of the funds of average shareholders, they receive preferential and

lower fees. Curiously, the Seventh Circuit was eager to compare comparable fees of unrelated investment products (hedge funds and mutual funds) but unwilling to contrast divergent fees of identical investment products (institutional and retail rates in mutual funds).

Since the publication of the decision below, however, jurists and commentators have begun to embrace the critical utility of comparing retail and institutional fees in what might be styled a *Gartenberg*-plus analysis. First, in his dissent from the denial of rehearing en banc in *Jones*, Judge Posner focused on this issue:

> A particular concern in this case is the adviser's charging its captive funds more than twice what it charges independent funds. . . . The panel opinion throws out some suggestions on why this difference may be justified, but the suggestions are offered purely as speculation, rather than anything having an evidentiary or empirical basis.

Jones, 537 F.3d at 731. Second, the Eighth Circuit in *Gallus* focused intensively on the fee discrepancy between institutional and retail investors in Ameriprise funds. The court overrode the advisor's objections, which relied on dicta in *Gartenberg* to dismiss such comparison on the grounds that the investments are not readily comparable and that any variances are justified by the greater costs associated with advising retail investors. Citing the expert report of Professor Charles Murdock, the court pointed out that the retail and institutional funds at issue "had identical investment objectives" and "very similar stock holdings," and that the advisor admitted in an internal email that it possessed no good justification for the difference: "we should have a reply,"

wrote an Ameriprise employee, "though it may or may not be convincing." *Gallus*, 561 F.3d at 819. Although Ameriprise ultimately produced a reply in the form of a report, the court questioned its "veracity and completeness." *Id.* The Eighth Circuit thus embraced an expanded notion of *Gartenberg* that more resolutely enforces the language and intent of Section 36(b).

Commentators have echoed these judicial statements, generally admonishing boards to be more demanding and empirically inquisitive of their advisors:

> Broadening *Gartenberg*'s comparative fee structure factor to include a comparison between the fees paid by mutual funds and institutional investors would introduce arm's-length bargaining, a proxy for fairness, into mutual fund excessive-fee cases.[33]

Another has noted that this Court "has an outstanding opportunity to endorse the more nuanced and sophisticated approach of Posner, which takes far greater account of the behavioral biases and distortions of investors."[34]

This relatively minor doctrinal modification, in conjunction with a far more sophisticated understanding of the operational and governance structures of mutual funds, would greatly enhance the quality of Section 36(b) jurisprudence. The ruling below constitutes a deliberate and radical departure from mutual fund precedent and from the congressionally enacted language of Section 36(b). With a moderate but vital enhancement of the *Gartenberg* doctrine, this Court can remind the investment

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[33] Johnson, *supra* note 32, at 40.

[34] Birdthistle, *Investment Indiscipline*, *supra* note 3, at 50.

advisory industry that the language of Section 36(b)'s fiduciary duty has meaningful force. By policing the duty's outer border, the federal courts can monitor the contours of any inflated fees while allowing the market to determine competitive rates.

CONCLUSION

For these reasons, *amici* respectfully urge this Honorable Court to reverse the ruling of the United States Court of Appeals for the Seventh Circuit.

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June 15, 2009

APPENDIX

APPENDIX

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AMICUS CURIAE BRIEF

Supreme Court, U.S.
FILED
JUN 17 2009
OFFICE OF THE CLERK

No. 08-586

IN THE
Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,
Petitioners,
v.
HARRIS ASSOCIATES L.P.,
Respondent.

On Writ of Certiorari
to the United States Court of Appeals
for the Seventh Circuit

BRIEF OF ROBERT LITAN, JOSEPH MASON, AND IAN AYRES AS *AMICI CURIAE* SUPPORTING PETITIONERS

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June 17, 2009

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INTERESTS OF *AMICI CURIAE*[1]

Amici are professors and academics who teach and write on financial economics. *Amici* wish to ensure that the Court properly assesses the limits of market forces in the mutual fund industry in deciding *Jones et al. v. Harris Associates*. *Amici* have no stake in the outcome of this case. They are filing this brief solely as individuals and not on behalf of the institutions with which they are affiliated.

Robert E. Litan is a Vice President for Research and Policy at the Kauffman Foundation in Kansas City, and a Senior Fellow in Economic Studies at the Brookings Institution. At Kauffman, Dr. Litan oversees a multi-million budget for academic research relating to entrepreneurship. At Brookings, Dr. Litan pursues a wide-ranging research agenda, which includes topics in regulation, financial institutions, telecommunications, and general economic policy. Dr. Litan has been a lecturer in banking law at the Yale Law School, consulted for numerous public and private organizations, and testified as an expert witness in a variety of legal and regulatory proceedings involving domestic (banking, antitrust) and international (primarily trade) issues. He also consulted for private sector firms and the Department of Justice on antitrust matters. Dr. Litan also has recently co-authored a book on the mutual fund

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1. No counsel for any party has authored this brief in whole or in part, and no person or entity other than *amici curiae* or their counsel has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. Counsel for petitioners filed a letter with the Clerk granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of respondent to the filing of this brief has been filed with the Clerk. *See id.*

industry titled *Competitive Equity: A Better Way to Organize Mutual Funds*, which was published in 2007. Dr. Litan also has served in several capacities in the federal government. During 1995 and 1996, he was Associate Director of the Office of Management and Budget (where he was responsible for overseeing budgetary and other policies of six cabinet agencies). From 1993 to 1995, he was Deputy Assistant Attorney General, in charge of civil antitrust litigation and regulatory issues, at the Department of Justice. From 1977 to 1979, he was the regulatory and legal staff specialist at the President's Council of Economic Advisers. In the early 1990s, Dr. Litan was a Member of the Commission on the Causes of the Savings and Loan Crisis. During his career, Dr. Litan has authored or co-authored over 20 books, edited another 14, and authored or co-authored over 200 articles in journals, magazines, and newspapers on a broad range of public policy issues. Dr. Litan received his B.S. in Economics, summa cum laude, from the Wharton School of Finance at the University of Pennsylvania; his J.D. from Yale Law School; and both his M. Phil. and Ph.D. in Economics from Yale University.

Joseph R. Mason is the Moyse/LBA Chair of Banking at the Ourso School of Business at Louisiana State University, and Senior Fellow at the Wharton School. Dr. Mason's academic research focuses primarily on investigating liquidity in thinly-traded assets and illiquid market conditions. Current academic research projects analyze default risk, including both immediate and cross-default risk, and default resolution costs in the contexts of asset-backed securities, in systemic and non-systemic environments, as well as the efficacy of bailout and

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Ian Ayres is the William K. Townsend Professor at Yale Law School and a Professor at Yale's School of Management. He has been ranked as one of the most prolific and most-cited law professors of his generation. Professor Ayres is a columnist for *Forbes* magazine and writes for the *New York Times'* Freakonomics Blog. He has been a commentator on public radio's Marketplace. His research has been featured on Primetime Live, Oprah, and Good Morning America and in *Time* and *Vogue* magazines. He currently is the editor of the *Journal of Law, Economics and Organization*. Professor Ayres clerked for the Honorable James K. Logan of the Tenth Circuit Court of Appeals. He has previously taught at Illinois, Northwestern, Stanford, and Virginia law schools and has been a research fellow of the American Bar Foundation. In 2006, he was elected to the American Academy of Arts and Sciences. His book with Gregory Klass, *Insincere Promises: The Law of Misrepresented Intent*, won the 2006 Scribes book award "for the best work of legal scholarship

published during the previous year." Professor Ayres has published 9 books and over 100 articles on a wide range of topics. In 2007, he published *Super Crunchers: Why Thinking-By-Numbers is the New Way to be Smart*. In the spring 2005, he published three books, *Straightforward: How to Mobilize Heterosexual Support for Gay Rights* (Princeton University Press 2005) (with Jennifer Gerarda Brown); *Optional Law: The Structure of Legal Entitlements* (University of Chicago Press 2005); and *Insincere Promises: The Law of Misrepresented Intent* (Yale University Press 2005) (with Gregory Klass). He also is the author of *Why Not?: How to Use Everyday Ingenuity to Solve Problems Big and Small* (2003) (with Barry Nalebuff); *Voting with Dollars: A New Paradigm for Campaign Finance* (2002) (with Bruce Ackerman); and *Pervasive Prejudice?: Non-Traditional Evidence of Race and Gender Discrimination* (2001). His two most cited articles are *Fair Driving: Gender and Race Discrimination in Retail Car Negotiations*, 104 Harvard Law Review 817 (1991), and *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale Law Journal 87 (1989) (with Robert Gertner). He is the author of several empirical studies: *Does Affirmative Action Reduce the Number of Black Lawyers?*, 57 Stanford Law Review 1807 (2005) (with Richard Brooks); *To Insure Prejudice: Racial Disparities in Taxicab Tipping*, 114 Yale Law Journal 1613 (2005) (with Fred Vars and Nasser Zakariya); *A Separate Crime of Reckless Sex*, 72 University of Chicago Law Review 599 (2005) (with Katharine Baker); *Shooting Down the More Guns, Less Crime Hypothesis*, 55 Stanford Law Review 1193 (2003) (with John J. Donohue III); *Measuring the Positive Externalities from Unobservable Victim Precaution: An Empirical*

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SUMMARY OF ARGUMENT

For at least two reasons, market forces cannot be relied upon to constrain the fees charged by mutual funds to competitive levels. *First*, recent discoveries in the behavioral finance literature reveal that the vast majority of investors cannot accurately assess the quality of the mutual funds in which they invest—that is, they do not behave rationally as predicted by economic models. Problems such as "misperceptions of chance," "sample-size neglect," "loss aversion," and "mental accounting" render the assessment of mutual fund performance extremely difficult for investors. Accordingly, the proposition that mutual fund investors will simply "fire" their advisers by "redeeming their shares and investing their assets elsewhere" ignores these natural impediments to competition.

Second, even if investors were purely rational, the mutual fund industry would still exhibit symptoms

of market failure due to what economists call "information costs." As demonstrated below, there is substantial evidence that the vast majority of mutual fund investors lack essential information necessary for them to make informed decisions. And the economic literature confirms that mutual funds have been effective in hiding their costs from investors. For example, certain funds provide fees in a fragmented fashion, where returns are reported before some fees and after others. Because many funds are held pursuant to a retirement plan such as 401(k), consumers do not fastidiously monitor fund fees. Combined with the cognitive-behavioral characteristics inherent to human beings described above, these information costs prevent fees from falling to efficient levels.

In light of these two impediments to efficient outcomes, the relevant question for an economist is how best to regulate fees in the mutual fund industry. We are reluctant to embrace price controls established through regulatory agencies. Regulators have been shown to be particularly bad at setting prices or avoiding capture by interested parties, especially in the absence of a natural monopoly. A better approach is to expose the few bad actors in the profession to legal liability.

We understand that the legal question raised in this matter is whether, when searching for a competitive "benchmark" rate, evidence of fees paid by comparable mutual funds should be given significant weight. For reasons we describe below, we do not believe such fees serve as a reliable benchmark; they will tend to be affected by the same forces that inflate defendant's fees. We advocate instead the use of fees set in the market for advisory

services to unaffiliated institutional clients, such as those paid to pension fund managers.

ARGUMENT

I. MARKET FORCES CANNOT BE RELIED UPON TO CONSTRAIN MUTUAL FUND FEES TO COMPETITIVE LEVELS

An essential foundation of the general economic conclusion that competition will discipline prices is that consumers in the market are well informed and make decisions that advance their self-interested, economic goals. The faster consumers detect low-quality products, the faster the market delivers high-quality products, ensuring efficient pricing. Although economic theory predicts that consumers will react to supra-competitive pricing by substituting their consumption to more reasonably priced alternatives, in the absence of reliable quality information, such substitution will not occur. Consequently, the normally effective market mechanism will not reliably bring prices in line with costs.

In the majority of markets, product quality information will be readily observable. Even in cases where product quality is not immediately apparent to consumers, the detection of poor quality products will be sufficiently likely that rational firms will price efficiently to avoid backlash and prevent the deterioration of their brand. However, when the observation of product quality is highly complex and detection of poor quality is difficult, real-world markets will fail to protect consumers from supra-competitive prices. As we discuss below, the structure and performance of the market for the financial services supplied by mutual funds indicate that the

normally reliable competitive mechanism has not engendered efficient pricing.

A. The Behavior of Investors Creates an Environment Where Competition May Not Protect Investors from Excessive Fees

The vast majority of investors cannot accurately assess the quality of the mutual funds in which they invest. That task is rendered extremely difficult by certain cognitive processes inherent to human beings. Beginning in the 1970s, economists and psychologists began to explore how psychological factors affected economic behavior. These initial researchers found that certain cognitive structures in the human mind caused people's behavior in the financial markets to deviate from what economists suspected rational actors would do. In the ensuing decades, the field now known as "behavioral economics" has come to be an enormously important field of economic research.[2] Its findings are highly relevant here as there are a number of extremely well-documented cognitive anomalies intrinsic in human behavior, which prevent individual investors from creating the competitive conditions necessary to induce mutual fund advisers to price commensurately with their performance. These cognitive anomalies combined with the inherently volatile nature of financial investments render it nearly impossible for the vast majority of investors to assess the price-adjusted quality of mutual funds.

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2. The application of behavioral economics to the study of finance is called behavioral finance. *See* Justin Fox, *The Myth of the Rational Market: A History of Risk, Reward, and Delusion on Wall Street* (Harper Business 2009).

One of the key problems facing mutual fund investors is the difficulty of making predictions about the fee-adjusted performance of a fund they are considering. Research in behavioral economics has demonstrated that people have an inherently poor grasp of probability. Early studies in the field demonstrated that, even in situations where the probabilities of an event could be easily calculated, people showed very little understanding of what those probabilities actually meant. As Daniel Kahneman, who won the Nobel Prize for Economics in 2002, and his frequent co-author Amos Tversky observed in an early paper, the vast majority of people are under the impression that, if a roulette wheel has repeatedly hit black, then red is somehow due. They explained these "misperceptions of chance" as follows: "Chance is commonly viewed as a self-correcting process in which a deviation in one direction induces a deviation in the opposite direction to restore the equilibrium." Amos Tversky & Daniel Kahneman, *Judgment under Uncertainty: Heuristics and Biases*, 185 Science 1124, 1125 (1974). This phenomenon is highly relevant to the evaluation of fund management performance because, even if some fund managers exhibit skill in their stock selection, their year-to-year returns will be highly influenced by probabilistic events—that is, the random fluctuations inherent to the stock market. Investors face an incredibly difficult task in discerning whether their money is being managed well. Such an assessment requires investors to distinguish whether the returns they observe are due to the skill of their advisers or to random chance. This challenge is complicated by the fact that the concept of probability is so hard to grasp in and of itself.

Another related problem that renders the assessment of mutual fund performance difficult for investors is what has been termed "sample-size neglect." This cognitive process results in people concluding that "[s]ix tosses of a coin resulting in three heads and three tails are as representative of a fair coin as 500 heads and 500 tails are in a total of 1000 tosses." Nicholas Barberis & Richard Thaler, *A Survey of Behavioral Finance*, NBER Working Paper No. 9222, at 13 (Sept. 2002). Sample-size neglect means that investors will be far too likely to consider a few years of above-average mutual fund performance evidence of managerial skill when in reality it has been driven by the random fluctuations inherent to the stock market. In fact, the link between sample-size neglect and misinterpretation of the performance of financial analysts has been directly recognized in the economic literature.[3]

In addition to cognitive biases that make the assessment of mutual fund quality a difficult if not intractable problem, the literature has identified a series of human behavioral characteristics that create substantial consumer inertia. One cognitive process that creates consumer inertia is known as "loss aversion." Loss aversion refers to the finding by behavioral economists that people find a proportionate loss more painful than they find a proportionate gain satisfying. *See* Daniel Kahneman,

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3. *See* Barberis & Thaler, *supra*, at 11 ("Sample size neglect means that in case where people do not initially know the data-generating process, they will tend to infer it too quickly on the basis of a few data points. For instance, they will come to believe that a financial analyst with four good stock picks is talented because four successes are not representative of a bad or mediocre analyst.").

Jack L. Knetsch & Richard H. Thaler, *The Endowment Effect, Loss Aversion, and Status Quo Bias*, 5 J. Econ. Persp. 193, 194 (1991). Loss aversion is highly relevant because it means that mutual fund investors may be unwilling to react to poor performance, even if they identify it. Thus, the proposition that mutual fund investors will simply "fire" their advisers by "redeeming their shares and investing their assets elsewhere," as two defenders of the mutual fund industry recently asserted, ignores these natural impediments to competition. *See* John C. Coates IV & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 160 (2007).[4] Due to the inherent difficulty investors face in evaluating the decisions of their money managers, it is simply not true that mutual investors will generally be able to identify a better investment option. Without well-informed consumers switching funds as punishment for poor performance, the market mechanism will not effectively push mutual fund advisory prices towards cost.

Furthermore, the inertia created by loss aversion is exacerbated by other related behavioral phenomena. A cognitive process that is particularly relevant to

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4. Coates and Hubbard purport to demonstrate this "elasticity" or responsiveness to high prices by estimating a negative relationship between a fund's fees and a fund's market share. But the authors themselves noted that there is no variation in individual fund fees, which implies that they could not analyze the effect of fees on the *change* in a fund's market share. Accordingly, their results merely show that, in a time of overall market expansion (1998 to 2004), lower-cost funds outperformed higher-cost funds. Even taking their results at face value, they provide no evidence that fees have been disciplined by competitive forces.

the lack of price competition in the mutual fund industry is known as "mental accounting" and was introduced to the economic lexicon in a seminal paper in 1985 by the prominent University of Chicago economist, Richard Thaler. Mental accounting refers to the propensity of people to treat individual bank accounts or investments separately from other sources of wealth. *See* Barberis & Thaler, *supra*, at 19. The result of this behavioral characteristic is that investors will not consider their financial investments in terms of an aggregate portfolio of investments as traditional financial economics assumes; instead, investors show a propensity for segregating their portfolios based on the principle of limiting their disutility from losses, exacerbating the effects of misperceptions of chance, sample-size neglect, and loss-aversion. Studies have confirmed that investors have a propensity to "sell winners too early and hold losers too long." Hersh Shefrin & Meir Statman, *The Disposition to Sell Winners Too Early and Ride Losers Too Long: Theory and Evidence*, 40 J. Fin. 777, 788 (1985); *see* Terrance Odean, *Are Investors Reluctant to Realize Their Losses?*, 53 J. Fin. 1775, 1795-97 (1998).

B. Limited Information About Fees Precludes Investors from Making Informed Decisions

Many of the cognitive processes discussed above suggest that the market failures in the mutual funds industry are caused by deviation from what is generally considered rational behavior in economics. Even if investors were purely rational, however, the mutual fund industry would still exhibit symptoms of market failure due to what economists call "information costs"—that is, the cost incurred by investors to overcome deficiencies in the information

provided by mutual funds. For example, some funds report fees in a fractured and segmented manner, which exacerbates the cognitive-behavioral issues described above.

There is substantial evidence that the vast majority of mutual fund investors lack essential information necessary for them to make informed decisions. For instance, the Securities and Exchange Commission ("SEC") recognized this information gap as an ongoing problem in a 2004 rule-making announcement.[5] The General Accounting Office ("GAO") also concluded that mutual fund investors would benefit from additional information about their advisers' fees. GAO, *Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition* 7 (June 2000). Similarly, a survey conducted by International Communications Research for a recent

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5. *See* SEC, Final Rule, Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies, 69 Fed. Reg. 11244, 11245 (Mar. 9, 2004) ("Despite these ongoing efforts, the degree to which investors understand mutual fund fees and expenses remains a source of concern. Mutual fund fees are of two types, transactional (*e.g.*, sales loads, redemption fees) and ongoing (*e.g.*, asset-based charges such as management fees and 12b-1 fees). While transactional fees are relatively transparent, ongoing fees are less evident because they are deducted from fund assets and are reflected in reduced account balances rather than being separately stated. Significant concerns have been raised regarding the degree to which investors understand the nature and effect of these ongoing fees. These ongoing fees can have a dramatic effect on an investor's return. A 1% annual fee, for example, will reduce an ending account balance by 18% on an investment held for 20 years. In December 2002, we proposed amendments intended to address these concerns, that would require a registered open-end management investment company to include in its shareholder reports disclosure of fund expenses borne by shareholders during the reporting period.") (footnotes omitted).

book on the mutual fund industry found investors to be poorly informed about fees. As financial experts Peter Wallison and Robert Litan explained in their recent comprehensive analysis of mutual fund fee arrangements, "the survey confirmed that investors are not well informed and do not believe themselves to be well informed about their mutual funds." Peter J. Wallison & Robert E. Litan, *Competitive Equity* 72 (AEI Press 2007). Indeed, the survey indicated that, even among participants who considered themselves the most informed about mutual fund advisory fees, only a small minority even knew they paid percentage advisory fees, and only a fraction of that group responded with a percentage in the vicinity of what mutual fund advisers generally charge. *Id.* at 73. Thus, investors not only have difficulty identifying the absolute amount of the advisory fees they pay, but are oblivious to what they pay relative to other investors.

The economic literature confirms that many mutual funds have been effective in hiding their costs from investors through fragmented reporting of fees. The results of a recent study by a group of economists indicate that, while first-time buyers are the most likely to pay obvious fees like loads and commissions, even experienced investors are likely to be insensitive to operating expenses. *See* Brad M. Barber, Terrance Odean & Lu Zheng, *Out of Sight, Out of Mind: The Effects of Expenses on Mutual Fund Flows* 19 (July 2002). The authors conclude: "Investors would benefit from a greater understanding and awareness of mutual fund expense. While educating investors is a complex and multifaceted task, our results support the [GAO's] recommendation that one step in that process would be for mutual funds to disclose to

investors the actual dollar amount of fees paid. Expenses that remain out of sight are likely to remain out of mind." *Id.* at 20. This conclusion was echoed in another recent paper, where the authors found that mutual funds have been able to reap stable profits from high-fee funds that take advantage of the most ill-informed investors.[6]

Between the cognitive processes that make it difficult for investors to recognize and reward high-quality, low-cost mutual funds and the lack of information consumers have on the fees they pay, the mutual fund industry is rife with the potential for market failure. In the next section, we examine the empirical evidence that confirms that the performance of the mutual fund market is not consistent with efficient pricing.

II. THE PERFORMANCE OF THE MUTUAL FUND INDUSTRY CONFIRMS THAT COMPETITION AMONG MUTUAL FUND ADVISERS DOES NOT EFFECTIVELY CONSTRAIN FEES

A growing body of empirical evidence shows that mutual funds have not consistently provided their investors with superior risk-adjusted returns. Yet despite their questionable track record, mutual fund advisers have achieved long-term growth in profits

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6. *See* Todd Houge & Jay Wellman, *The Use and Abuse of Mutual Fund Expenses*, 70 J. Bus. Ethics 23, 31 (2007) ("Mutual funds aggressively advertise historical performance but rarely compete on expenses Even though these fees represent a deadweight cost on long-term returns, few investors can actually estimate the annual expenses of their fund holdings. We contend the fund industry has become very adept at segmenting customers by level of investment sophistication. The industry uses this ability to market high expense funds to less-knowledgeable customers.").

that is inconsistent with a competitive market. Combined, such evidence strongly suggests that market forces are not functioning properly.

A. Mutual Fund Advisers Have Not Consistently Provided Fund Investors with Superior Risk-Adjusted Returns

There is a substantial empirical literature demonstrating that high-fee, actively managed mutual funds have not provided investors with returns any greater than those they would have earned buying low-fee funds that track a stock index like the S&P 500. For instance, the renowned financial economist Burton Malkiel found in a study of mutual fund performance over the period 1971 to 1991 that, "[i]n aggregate, funds have underperformed benchmark portfolios both after management expenses and even gross of expenses." Burton G. Malkiel, *Returns from Investing in Equity Mutual Funds 1971 to 1991*, 50 J. Fin. 549, 549 (1995). Additional articles released more recently have also found scant evidence of superior performance from actively managed mutual funds. *See* Mark M. Carhart, *On Persistence in Mutual Fund Performance*, 52 J. Fin. 57 (1997); Laurie Prather, William J. Bertin & Thomas Henker, *Mutual Fund Characteristics, Managerial Attributes, and Fund Performance*, 13 Rev. Fin. Econ. 305 (2004).

To be sure, some active managers have achieved superior returns than those realized by the broader indices. But the empirical literature demonstrates that the vast majority of funds do not provide their investors with superior returns. As a group of prominent financial economists wrote in a Brookings research paper: "While our results suggest quite

clearly that the average or the median fund manager does not add value during our sample period, some funds in some years show superior performance." Josef Lakonishok, Andrei Shleifer & Robert W. Vishny, *The Structure and Performance of the Money Management Industry*, Brookings Papers: Microeconomics 356 (1992). Furthermore, other research has suggested that the persistence of superior returns by certain funds is explained by factors other than managerial skill. As economist Mark Carhart explained in a paper considering this evidence: "Persistence in mutual fund performance does not reflect superior stock-picking skill. Rather, common factors in stock returns and persistent differences in mutual fund expenses and transaction costs explain almost all of the predictability in mutual fund returns. Only the strong, persistent underperformance by the worst-return mutual funds remains anomalous." Carhart, *supra*, at 58.

A particularly salient finding for the issues raised here is that high fees can be directly attributed to poor performance. The direct relationship between low fees and superior performance was first explored in a 1966 paper by Nobel Prize winning economist William Sharpe, who found that the mutual fund performance and mutual fund fees are *negatively* related—that is, the lower the fees the better the returns for investors. This counter-intuitive result also has been demonstrated in more recent research. *See* Malkiel, *supra*, at 568; Carhart, *supra*, at 58. For instance, Dr. Carhart finds that expenses, active trading by fund managers, and load fees are all correlated with negative mutual fund performance. *See* Carhart, *supra*, at 58.

A common response to the argument that behavioral quirks of mutual fund investors have prevented the mutual fund industry from operating efficiently is that the presence of a few rational investors will protect the rest. Indeed, this is the line of argument the Seventh Circuit articulated in the decision below.[7] However, in any science, theory must be borne out by the facts. As discussed above, there is clear *empirical evidence* that, contrary to the "few-sophisticated-investors hypothesis," high advisory fees are actually associated with poor performance. Moreover, even the economists who have found superior performance at a few standout funds acknowledge that, for the vast majority of funds, fees are not set in accordance with performance.

B. Despite Their Questionable Track Record, Mutual Fund Advisers Have Achieved Long-Term Growth in Profits That Is Inconsistent with a Competitive Market

Despite the questionable performance of mutual funds (relative to broad indices), mutual fund advisers are earning persistent profits far above their costs. First, some background on the industry is essential. Mutual funds have grown by enormous proportions over the previous decades. In 1940, the total assets held by the mutual fund industry totaled $450 million; by 2006, this figure exceeded $10 trillion, representing an approximately 2,000-fold increase in nominal terms. *See* Wallison & Litan, *supra*, at 41. A recent law review article documented that residual payments to fund managers and their

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7. *Jones v. Harris*, 527 F.3d 627, 634 (7th Cir. 2008) ("It won't do to reply that most investors are unsophisticated and don't compare prices. The sophisticated investors who do shop create a competitive pressure that protects the rest.").

affiliates and service providers net of all relevant costs have risen from $1.5 billion to $90 billion per year over the period from 1980 to 2006. Adjusted for inflation, this growth represents approximately a 23-fold increase in real compensation.[8] *See* John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 91 (2008). Thus, mutual fund advisers have had enormous success over the previous decades. As we discuss below, the empirical economic literature has demonstrated that much of this success represents persistent economic profits detrimental to consumers and overall economic efficiency.

Two recent academic papers provide direct evidence that the fees charged by mutual fund advisers in aggregate have resulted in fee structures that would not persist in a fully competitive environment. The first concludes that low-quality funds actually charge investors higher fees than high-quality funds, all other things being equal. The authors explain: "[P]ut together, the empirical evidence implies that superior management is not priced through higher expense ratios. On the

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8. The inflation calculation is based on a comparison of the CPI-U in January 1980 to the CPI-U in January 2006 available at ftp://ftp.bls.gov/pub/special.requests/cpi/cpiai.txt. The Bureau of Labor Statistics reports that in January 1980 the CPI-U index had a value of 77.8, while in January 2006 it had a value of 198.3. Dividing 198.3 by 77.8 yields a figure of approximately 2.55. Multiplying mutual fund advisers total compensation of $1.5 billion in 1980 by 2.55 yields a value of $3.83 billion—the value of adviser compensation in 1980, in 2006 dollars. Dividing $90 billion by $3.83 billion yields a value of 23.49, representing the factor by which advisers real compensation has increased over the period from 1980 to 2006.

contrary, it appears that the effect of expenses on after-expense performance (even after controlling for funds' observable characteristics) is more than one-to-one, which would imply that low-quality funds charge higher fees." Javier Gil-Bazo & Pablo Ruiz-Verdu, *When Cheaper is Better: Fee Determination in the Market for Equity Mutual Funds*, 67 J. Econ. Behav. & Org. 871, 883 (2008). Of course, in an effectively competitive market, this *negative* relationship between fees and quality simply would not exist. A second article concludes that the fees charged by mutual fund advisers represent persistent economic profits that would not persist under more competitive circumstances, leading to the conclusion that, in the aggregate, "the majority of the [mutual fund] fee is explained by mark-ups that funds add to the marginal cost owing to the market power possessed by the funds." Guo Ying Luo, *Mutual Fund Fee-Setting, Market Structure and Mark-ups*, 69 Economica 245, 245 (2002). Thus, the overwhelming evidence is that competition in the mutual fund industry has not produced competitive outcomes.

III. EXCESSIVE-FEE LITIGATION IS AN IMPORTANT TOOL FOR CORRECTING THE MARKET FAILURES INHERENT TO THE MUTUAL FUND INDUSTRY

Excessive-fee litigation represents a non-regulatory option for restraining abuses in the mutual fund industry. Importantly, it preserves the underlying market mechanism that rewards innovation. Because all mutual funds suffer from the same "costly state verification" problems, comparisons to fees paid by other mutual funds are not the appropriate benchmark for assessing fees charged by an investment adviser. And the arguments advanced by investment advisers against using pension fund

fees as the proper benchmark in the context of excessive-fee litigation are not grounded in solid theory or evidence.

A. Excessive-Fee Litigation Provides a Check on Investment Advisers Without Undermining the Underlying Market Mechanism

It is important that the empirical findings described above be understood in their proper context. The fact that certain characteristics of the fund industry have prevented it from serving consumers as efficiently as possible does not mean that a tighter regulatory apparatus is desirable or even that competition has been completely ineffective. Under the current regulatory environment, the Vanguard mutual fund complex has grown impressively by offering consumers low-fee investment options. *See* Wallison & Litan, *supra*, at 84. Full-scale regulation is likely to retard the emergence of innovators like John Bogle of Vanguard, who recognized a niche that sophisticated investors have embraced.

Despite Vanguard's success in low-cost funds, its model has not been imitated. Indeed, even Vanguard has been attracted to the higher fees offered by actively managed funds in recent years. When the bulk of investors are not able to gauge accurately the quality of their mutual funds, even firms that gained success on the basis of low-margin offerings can be attracted to the greater earnings obtained by making fees more opaque. This economic fact means that competition among funds will not be sufficient in and of itself to discipline the prices charged by investment advisers. While regulated fee limits will result in funds charging the maximum fees allowed (regardless

of quality), excessive-fee litigation maintains incentives for advisers to charge fees according to their actual costs and the value they add, consistent with a truly competitive market.

B. Facile Comparisons to Other Mutual Funds Are Not the Appropriate Benchmark for Assessing the Fees Charged by an Investment Adviser in an Excessive-Fee Case

What evidence should courts consider in excessive-fee litigation, given the fact that rates paid by other mutual funds may very well be inflated above their competitive levels? Economic research suggests that competition works more effectively in the market for pension fund money management: "In contrast to mutual fund investors, pension clients punish poorly performing managers by withdrawing assets under management and do not flock disproportionately to recent winners." Diane Del Guerico & Paula A. Tkac, *The Determinants of the Flow of Funds of Managed Portfolios: Mutual Funds vs. Pension Funds*, 37 J. Fin. & Quantitative Analysis 523, 523 (2002).

The view that fees paid to the advisers of pension funds can be used to assess the competitiveness of mutual fund fees was recently criticized by Coates and Hubbard. In particular, the authors argue that the cost of providing both services differs, which justifies fee differences. *See* Coates & Hubbard, *supra*, at 185. Coates and Hubbard claim that the expense categories reported by mutual funds make it impossible to separate the cost of portfolio management from other costs, like administrative or marketing costs, incurred by mutual funds. As a result, they claim that it is impossible to identify a measure of the cost of managing a mutual fund

portfolio that is truly comparable to the cost of managing a pension fund. *Id.* at 186. Furthermore, they argue that, even if this comparison could be made, it would remain inapposite because mutual funds must have greater liquidity than pension funds to ensure that shares are redeemable upon request. *Id.*

But these arguments rely on specious economic logic. From the perspective of setting fees, economics teaches us that the only costs that matter are *marginal* costs—that is, the additional cost of serving the last customer. The cost concerns voiced by Coates and Hubbard are not relevant, because the administrative and marketing fees incurred by mutual funds (both *fixed* costs) will play a negligible role in the cost of serving the marginal mutual fund customer.

Additionally, a recent article in the Oklahoma Law Review belies the argument advanced by Coates and Hubbard that pension fund management fees cannot be used to evaluate the competitiveness of the associated fees for mutual funds. The authors show that, when sufficient cost data have been made available through legal or regulatory inquiries, the fees associated with the pure cost of portfolio management for mutual fund investors greatly exceed those charged to pension fund clients. *See* Freeman, Brown & Pomerantz, *supra*, at 110-12. The authors also show that the liquidity argument is a red-herring because portfolio management fees are not substantially different between mutual funds and closed-end funds that do not issue redeemable shares. *Id.* at 114. In summary, the arguments against comparing mutual fund fees to pension fund

management fees are theoretically untenable and empirically inaccurate.

CONCLUSION

For these reasons and those more fully developed in petitioners' briefing, the Court should overturn the finding by the Seventh Circuit that competition between mutual funds has forced mutual fund advisers to price efficiently. The cognitive-behavioral characteristics inherent to people and the costs of obtaining full information on advisory fees have led to a market failure in the supply of mutual fund advisory services. Those who insist that the mutual fund advisory market is operating efficiently have simply ignored the fee-adjusted performance record of advisers, which simply cannot be consistent with a well-functioning, competitive market. Allowing courts to use a reasonable competitive benchmark like the fees advisers charge to pension fund clients in evaluating excessive fee cases will encourage the mutual fund industry to price more efficiently and increase consumer welfare.

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June 17, 2009

AMICUS CURIAE BRIEF

(21)

No. 08-586

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES,
AND ARLINE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES L.P.,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF *AMICUS CURIAE* MUTUAL FUND DIRECTORS FORUM IN SUPPORT OF RESPONDENT

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Letter from William H. Donaldson, Chairman, SEC, to David S. Ruder & Allan S. Mostoff, Mutual Fund Directors Forum (Nov. 17, 2003) 40

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Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, 9 ICI PERSPECTIVE 1 (Aug. 2003) 40

Harvey L. Pitt, Chairman, SEC, *Remarks at Mutual Fund Directors Forum* (Jan. 8, 2003) 40

INTEREST OF THE *AMICUS*[1]

The Mutual Fund Directors Forum (the "Forum") is an independent, non-profit membership organization for the independent directors of investment companies.[2] The Forum is dedi-

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[1] No counsel for any party has authored this brief in whole or in part, and no party or counsel for a party has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. All parties have been timely notified of the undersigned's intent to file this brief; petitioners have filed a blanket consent with the Court to the filing of all *amicus* briefs; respondent has also consented to the filing of this brief. A copy of respondent's consent is filed herewith.

[2] The Forum grew out of the Mutual Fund Directors Education Council, a group convened in 1999 in response to a call for improved fund governance by then-SEC Chairman Arthur Levitt. *See* Press Release SEC, 99-130 (Oct. 13, 1999), *available at* http://www.sec.gov/news/press/press archive/1999/99-130.txt ("Securities and Exchange Commission Chairman Arthur Levitt today praised the creation of the Mutual Fund Directors Education Council. . . . The Council will foster and seek to encourage the development of programs to promote a culture of independence and accountability in fund boardrooms."). Each of the Forum's member groups selects a representative to serve on the Forum's Steering Committee, and the views expressed in this *amicus* brief have been reviewed by the Steering Committee and approved by the Forum's Board of Directors. The Forum's members are all independent directors. A member of the Oakmark Fund board is on the Board of the Forum, but has not participated in the drafting of this brief.

cated to improving mutual fund governance through continuing educational programs and the publication of "best practices" guides.[3] The Forum is financially independent from the advisory firms that sponsor and manage mutual funds.

Under the statutory scheme at issue in this case, the independent directors of a mutual fund are responsible in the first instance for evaluating and approving advisory fee agreements between the fund and its investment adviser. This role is especially relevant to the resolution of this case because, under the governing statutory scheme, Congress has directed that, in reviewing a claim challenging an adviser's compensation, a court is required to give appropriate consideration to a board's approval of the advisory agreement.

Drawing on the Forum's particular expertise, the purpose of this brief is to explain how and why the board's role is critical to Congress' statutory scheme. In particular, this brief focuses on how the relevant statutory and regulatory scheme has empowered independent directors to fulfill Congress' regulatory purpose, and

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[3] *See, e.g.*, Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004).

why, absent unusual circumstances, deference to the decision of a board to approve an advisory contract is a critical component of any judicial review of a claim challenging the adviser's fees.

PRELIMINARY STATEMENT

The issue before the Court is the proper construction of section 36(b) of the Investment Company Act of 1940 (the "ICA" or "Act"). As is relevant here, section 36(b) has three prominent features. First, it provides that an adviser to a mutual fund is "deemed to have a fiduciary duty with respect to the receipt of compensation for services" rendered to the fund. 15 U.S.C. § 80a-35(b) (2006). Second, it permits a shareholder of a fund to pursue a cause of action against the adviser on behalf of the fund for an adviser's "breach of fiduciary duty in respect of such compensation." *Id.* Third, it provides that, in any action brought under section 36(b), the decision of the fund's board of directors approving the contract governing the adviser's compensation "shall be given such consideration by the court as is deemed appropriate under all the circumstances." *Id.*

As the last of these three features makes plain, when a court reviews a claim under section 36(b), it is not enough for the court to consider by itself the scope of an adviser's fiduciary duty under the statute or whether the adviser has breached its duty in some way. Rather, the

statute directs that the court must also take into account the board's decision to approve the contract setting the adviser's fee. This direction underscores a key element of the statutory scheme that petitioners largely ignore—namely, that Congress intended independent boards to serve in their own right as a critical means to assess whether an adviser's fee is appropriate. Moreover, it is evident from review of the legislative scheme and its history that Congress intended the board to have flexibility in its decision making: Congress chose not to dictate the factors boards must consider in approving an advisory contract, let alone the weight to be given any particular factor. Instead, Congress intended that each board would evaluate the appropriateness of an adviser's services and fees consistent with the particular needs and interests of the relevant fund.

In order to properly acknowledge the board's role in accordance with the statutory scheme Congress created, it cannot be true that, in an ordinary case, a board's decision to approve a contract may be ignored. On the contrary, absent unusual circumstances, a board's decision to approve a particular contract is entitled to deference. Otherwise, the statutory scheme that Congress designed cannot function as Congress intended.

The purpose of this *amicus* brief, rooted in the Forum's perspective and experience, is two-fold. First, it explains the central role that independent directors have always played in protecting shareholders under the ICA, how that role is reflected in section 36(b), and hence why, absent unusual circumstances, deference to a board's decision to approve an advisory contract is a critical component of Congress' statutory scheme. Second, it discusses how in recent years the Securities and Exchange Commission ("SEC") has strengthened the board's ability to negotiate advisory contracts as in an arms'-length manner, how the industry itself has taken steps to enhance the board's effectiveness in this regard, and why these measures further support the conclusion that, absent unusual circumstances, a board's consideration and approval of an advisory contract is entitled to deference.

In this case, there appears to be no demonstration that the board neglected its duties. The District Court observed that board members reviewed and evaluated information "regarding the funds' performance, the services [the adviser] provided to the funds, comparisons with fees charged to Harris's other clients, and comparisons with fees charged by other companies man-

aging similar funds."[4] Likewise, the Court of Appeals determined that there appears to be no contention that the adviser deceived the board or "pulled the wool" over its eyes in fixing the adviser's compensation. In other words, this is not an unusual case, and under all the relevant circumstances, it appears that the board acted responsibly, in an informed and engaged way, in approving the adviser's compensation. Accordingly, under these circumstances, its decision should be accorded deference, and the judgment of the Court of Appeals should be affirmed.

SUMMARY OF THE ARGUMENT

As is relevant here, the history of section 36(b) reflects three predominant themes. First, rather than abandon board decision making in establishing appropriate adviser compensation, Congress has entrusted and empowered independent directors to have the primary role in this area. Second, the SEC and the industry have taken steps to strengthen the ability of boards to fulfill their assigned role. Third, courts reviewing claims under section 36(b) have prop-

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[4] *Jones v. Harris Assocs. L.P.*, No. 04C8305, 2007 WL 627640, at *1 (N.D. Ill. Feb. 27, 2007); *see also* Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004) (discussing procedures boards should follow in reviewing advisory contracts).

erly recognized the importance of responsible director decision making. The seminal case in this regard is the Second Circuit's decision in *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*[5]—a decision that properly views the role of the board as central to the statutory scheme and the purposes underlying it.

As the history of section 36(b) reveals, Congress did not intend any single factor to control the question whether a board has behaved responsibly in approving an adviser's compensation. In particular, Congress consciously disapproved the notion that a comparison between the fees an adviser charges its mutual fund and nonmutual fund clients is entitled to any sort of special consideration or weight. Boards should properly tailor their decision making to the facts and circumstances before them, and Congress did not purport to dictate the details of how the board should fulfill its duties.

In this case, there is no demonstration that the board neglected its duties under the ICA, or was deceived in some material way. In other words, it appears that there are no unusual circumstances that would warrant disregarding the board's decision to approve the advisory contract.

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[5] 694 F.2d 923 (2d Cir. 1982).

Accordingly, the judgment of the Seventh Circuit affirming the District Court should be affirmed.

ARGUMENT

Review of the ICA reveals that its purpose is not to fix the amount of fees in an advisory contract. Nor is it to replace a fund's board with a court or administrative agency in the evaluation and approval of the amount of an adviser's compensation, or to dictate the factors that boards must consider in the evaluation and approval process. Rather, in key respects, the structure of the ICA and its implementing regulations entrust the board with responsibility for evaluating and approving advisory contracts, rely on the board to fulfill these functions, and seek to enhance these functions in several critical, interlocking ways, reserving judicial intervention for truly unusual circumstances.

Petitioners observe that advisers and their mutual fund clients often enjoy a close relationship, giving rise to the potential for a conflict of interest in the setting of the adviser's fees. Petitioners contend that advisory fees ought to resemble the product of arms'-length bargaining. While the Forum agrees with this contention, it disagrees with the mechanical means petitioners urge to test the appropriateness of the adviser's fees. As a talismanic benchmark for evaluating claims under section 36(b), petitioners urge a comparison between the fees the adviser charges

its mutual fund client with the fees charged to non-mutual fund clients. Petitioners' focus on this factor as a litmus test is misplaced. During the legislative process, Congress consciously rejected a proposal that would have required a comparison of the kind petitioners advocate. Under Congress' scheme as enacted, although a comparison of the different fees advisers charge their various clients is something a board may consider in evaluating a particular contract, it is not controlling—far from it. Further, where the board considers a comparison of the different fees an adviser charges its various clients, it is up to the board to decide its relative weight in the overall analysis. This is particularly true given that the services the adviser provides to its various mutual fund and non-mutual fund clients may well be substantially dissimilar. More generally, what petitioners fail properly to acknowledge is that the provisions of the ICA itself, augmented by the SEC's regulations and evolving industry practices, are designed to create the functional equivalent of an arms'-length process.

First, the ICA confronts directly the conflict of interest problem that petitioners identify by assigning the central role in the advisory contract evaluation and approval process to a fund's *independent* directors—*i.e.*, those who are

strictly unaffiliated with, and without an interest in, the adviser.[6] Among other things, section 15(c) of the Act requires that a majority of the independent directors approve the advisory contract, by vote cast in person at a meeting called for that specific purpose. 15 U.S.C. § 80a-15(c).[7]

Second, section 15(c) requires that the directors obtain and evaluate information reasonably necessary to consider and approve the advisory agreement, and for this purpose requires the adviser to supply information the board requests. *Id.* This information-gathering and approval function is necessarily flexible. Funds can feature vastly different investment strategies and call for distinctly different ser-

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[6] *See* 15 U.S.C. § 80a-2(a)(19) (2006) (defining "interested person").

[7] As the SEC has explained, the role of the fund's independent directors is to serve as "independent watchdogs" charged with furnishing a crucial check on fund management and providing a means for the representation of the interests of the shareholders of a fund. Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24,083, 64 Fed. Reg. 59,877 (Nov. 3, 1999); *see also Burks v. Lasker*, 441 U.S. 471, 484 (1979) (quoting *Tannenbaum v. Zeller*, 552 F.2d 402, 406 (2d Cir. 1977) and *Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong. 109 (1940) (statement of David Schenker, Chief Counsel, SEC Investment Trust Study)).

vices. Boards are intimately familiar with the particular operations of their funds, and boards are thus uniquely able to evaluate the appropriateness of advisers' services and fees. Moreover, after an initial two-year term for a new contract, this evaluation and approval process must take place every year in order for the advisory relationship to continue. No mechanically-applied benchmark analysis of the kind petitioners advocate can properly serve as a legitimate proxy for this tailor-made process.

Third, supplementing the Act's essential independence and disclosure structures, the SEC has, since 1970, adopted regulations that have effectively increased the influence and power of independent directors. Since its inception, the ICA has always required that at least 40% of a fund's directors be independent. Under more recent SEC regulations, that required percentage has effectively increased to greater than 50%. The SEC has also issued rules and regulatory guidelines that have helped structure the process of board consideration and approval of advisory contracts. Again, the mechanical benchmark analysis that petitioners advocate is at odds with this regulatory model.

Fourth, boards themselves have embraced their role and, with the assistance of the Forum, as well as industry organizations, have adopted practices that have enabled them to become

steadily more proficient and proactive in evaluating and approving advisory contracts within the regulatory structure that Congress and the SEC have created.

Critically, the whole point of these various provisions, regulations, and practices is to establish a structured environment for responsible decision making over advisory fees in which a board conducts its evaluations informed by access to a broad range of information and with the advantage of critical expertise and practical experience. Given that Congress has gone to great lengths to create this regime after careful study and extensive deliberations, it cannot be presumed that Congress intended it to be ineffective or irrelevant in evaluating claims under section 36(b). On the contrary, the fact that Congress directed that courts "shall" consider the board's approval of a contract in evaluating a claim under the section demonstrates the opposite: absent unusual circumstances, a board's decision is properly entitled to deference.

A. The Centrality of the Role of Independent Directors under the ICA both Before and After Its Amendment in 1970

In drafting and passing the original provisions of the ICA in 1940, Congress understood that advisers typically sponsor the mutual funds they subsequently advise, and believed that fund shareholders would be adequately protected by a "few elementary safeguards" to protect against abuse.[8] In particular, as noted, the original legislation mandated that at least 40 percent of a fund's directors had to be unaffiliated with the fund's investment adviser-sponsor.[9] It also provided that advisory contracts would have to be approved initially by a majority of the outstanding voting shares of the fund. Thereafter,

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[8] *Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Comm. on Banking and Currency*, 76th Cong. 252 (1940) (testimony of David Schenker, Chief Counsel, SEC Investment Trust Study).

[9] Investment Company Act of 1940, Pub. L. No. 768, ch. 686, § 10(a), 54 Stat. 789, 806 (1940) (amended 1970). The definition of an affiliated person, however, was not particularly rigorous. *Id.* § 2(a)(3). A new section was later added to the statute as part of the 1970 amendments, which tightened the independence requirements for directors by introducing the concept of "interested person" and substituting it for "affiliated person" in section 10(a). 15 U.S.C. § 80a-2(a)(19), 80a-10(a) (2006); *see also infra* notes 40-41 and accompanying text.

the contract was required to be approved annually, either by the shareholders or by the fund's board of directors, including a majority of unaffiliated directors.[10]

As the legislative history shows, it was not Congress' intention in 1940 to upset shareholder expectations that a fund's board would ordinarily retain the adviser shareholders had chosen.[11] In selecting a fund, investors are selecting a particular money manager, and Congress understood that retaining a particular adviser was frequently to the funds' advantage because an affiliation with a particular adviser could be a significant benefit in terms of attracting and retaining assets.[12]

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[10] 15 U.S.C. § 80a-10(a), 80a-15 (2006).

[11] *See Investment Trusts and Investment Companies: Hearings on H.R. 10065 Before a Subcomm. of the Comm. on Interstate and Foreign Commerce*, 76th Cong. 109-10 (1940) (testimony of David Schenker, Chief Counsel, SEC Investment Trust Study):

> If the stockholders want A's management, then A should have the right to impose his investment advice on that company. However we felt that there should be some check on the management and that is why the provision for 40 percent of independents was inserted.

[12] *See* Alfred Jaretzki, Jr., *The Investment Company Act of 1940*, 26 WASH. U. L.Q. 303, 319 (1941).

Congress' views, reflected in the legislation it adopted, facilitated remarkable growth in the industry. Investors flocked to mutual funds, which flourished and proliferated.[13] Eventually, however, a number of issues emerged, prompting Congress to revisit and amend, but not fundamentally restructure, its regulatory scheme. As is relevant here, rather than abandon reliance on boards, Congress chose to strengthen and enhance the role of independent directors to protect against excessive adviser fees, and required appropriate consideration of the directors' decision to approve an advisory contract in any suit challenging the adviser's compensation.

1. The Wharton Report

As the mutual fund industry grew, the compensation that advisers received based on a percentage of assets under management also grew, giving rise to concerns about the dollar amount of the fees. In 1958, the SEC enlisted the Wharton School of Finance and Commerce to produce a study on the mutual fund industry, and to analyze "the question of the effects of size on investment policies and comparative performance of [funds] and, to the extent possible, to the effects of size of [funds] on the securities

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[13] Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. REP. No. 87-2274, at 4 (1962).

markets and on the policies of portfolio companies."[14] The Wharton Report was delivered to Congress in 1962.[15]

The Wharton Report concluded, among other things, that "[a]dvisory fee rates charged by mutual funds tended to be substantially higher than those charged by the same advisers to the aggregate of their clients other than investment companies, for comparable asset levels."[16] Combined with later reports and testimony, the Wharton Report set the stage for subsequent amendment of the ICA in 1970, yielding the current section 36(b). Critically, although the Wharton Report clearly identified a disparity between the fees advisers charged their mutual fund clients and the fees that they charged to their non-mutual fund clients, Congress ultimately rejected a proposal that would have directed a comparison between these fees in reviewing claims under section 36(b). Instead, as discussed more fully below, Congress continued to rely on responsible director approval of advisory contracts as the primary means of ensuring appropriate levels of compensation.

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[14] *Id.* at 1 (internal quotation marks omitted).

[15] S. REP. No. 91-184, at 4 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4900.

[16] Wharton School of Finance and Commerce, *A Study of Mutual Funds*, H.R. REP. No. 87-2274, at 29 (1962).

2. The 1966 Report and Legislative Proposals Leading up to the 1970 Amendments

Following the Wharton Report in 1962, and the SEC's own report on the securities laws in 1963,[17] the SEC undertook and prepared a subsequent report (the "1966 Report") regarding the ICA, arguing that amendments to the statute were necessary to protect the interests of fund shareholders from excessive fees.[18] The report stated:

> Because the Act fails to articulate clearly the standard by which the propriety of managerial compensation should be measured, it makes for uncertainty and impairs rather than strengthens the fiduciary obligation of investment company managers to refrain from compensating themselves unfairly. If the Act is to be an effective force for fairness and equity in this area, the "few elementary safeguards," deemed adequate

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[17] SEC, *Report of the Special Study of the Securities Markets*, H.R. Doc. No. 88-95 (1963).

[18] SEC, *Public Policy Implications of Investment Company Growth*, H.R. Doc. No. 89-2337, at 143 (1966).

> for the industry of 1940 must now be supplemented.[19]

The SEC recommended in its report that Congress amend the ICA to add a section that would permit evaluation of advisory fees under a "Federal standard of reasonableness."[20] Fleshing out its standard, the SEC enumerated a list of considerations to be used in determining reasonableness.[21] Notably, the first factor appearing on the SEC's list was "the fees paid for comparable services by other financial institutions [engaged in administering] pools of investment capital of like size and purpose such as pension and profit sharing plans, insurance companies, trust accounts, and other investment companies."[22]

Following the 1966 Report, legislation to implement the SEC's recommendations was in-

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[19] *Id.*

[20] *Id.* at 146.

[21] *Id.* at 144.

[22] *Id.* The other factors included "the nature and quality of the services provided; all benefits directly or indirectly received by persons affiliated with an investment company and their affiliated persons by virtue of their relationship with an investment company; and such competitive or other factors as the Commission may by rule or regulation . . . determine are appropriate and material in the public interest." *Id.*

troduced in May 1967 in both Houses of Congress (S. 1659 and H.R. 9510).[23] The identical bills included a new Section 15(d) of the Act, which incorporated the SEC's suggested standard and proposed that advisory fees would be measured against a new yardstick of "reasonableness."[24] Like the 1966 Report, the bills listed factors to be employed in determining whether the fees that an adviser proposed to charge were reasonable.[25] With respect to com-

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[23] S. 1659, 90th Cong. (1967); H.R. 9510, H.R. 9511, 90th Cong. (1967).

[24] S. 1659, 90th Cong. § 8(d)(1) (1967), *reprinted in Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong. 915-16 (1967); *see also* SEC, *Public Policy Implications of Investment Company Growth*, H.R. Doc. No. 89-2337, at 144 (1966); H.R. 9510, H.R. 9511 90th Cong. § 8(d)(1) (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 8 (1968).

[25] Section 8(d)(2)(A)-(E) of S. 1659 proposed five factors to be used to determine reasonableness:

> (A) The nature and extent of the services to be provided...; (B) The quality of the services theretofore rendered . . .; (C) The extent to which the compensation provided for in such contract takes into account economies attributable to the growth and size of such investment company . . .; (D) The value of all benefits, in addition to compensation provided for in

paring fees paid by a mutual fund and fees paid by other types of clients, the bills directed consideration of the following:

> The extent to which the compensation provided for in such contract takes into account economies attributable to the growth and size of such investment company and any such economies attributable to the operation of other investment companies under common management with such company, *giving due consideration to the extent to which such economies are reflected in the charges made or compensation received for investment advisory services and other services provided to investment companies having no investment adviser, other clients of*

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such contract . . .; [and] (E) Such other factors as are appropriate and material.

S. 1659, 90th Cong. § 8(d)(2)(A)-(E) (1967), *reprinted in Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong. 916-17 (1967); *see also* H.R. 9510, 90th Cong. § 8(d)(2)(A)-(E) (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 8 (1968).

> *investment advisers and other financial institutions, but with due allowance for any relevant differences in the nature and extent of the services provided.*[26]

Thus, the bills would have required the comparison only as an adjunct to a broader inquiry into economies of scale.

During July and August 1967, the Senate Committee on Banking and Currency held extensive hearings on S. 1659. During October 1967, the House Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce held hearings on H.R. 9510. Manuel F. Cohen, then chairman of the SEC, testified in the House Subcommittee proceeding, stating:

> Specifically, the Commission recommends that Section 15 of the Act be amended to provide that the compensation received for any service rendered directly or indirectly to a fund or its shareholders by an

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[26] H.R. 9510, 90th Cong. § 8(d)(2(C) (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 8 (1968) (emphasis supplied).

> investment adviser . . . shall be *reasonable*. This would provide an explicit federal standard of fairness and reasonableness, as is normally applied in reviewing corporate transactions when a conflict of interest exists.[27]

Negotiations with representatives of the mutual fund industry resulted in a new bill, S. 3724, in July 1968. S. 3724 retained the reasonableness test for advisory fees and the approach of including a list of factors to be considered in determining reasonableness.[28] Significantly, however, the revised list of factors appearing in S. 3724 *omitted comparison with fees charged to other non-fund clients.*[29] According to the report

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[27] H.R. 9510, 90th Cong. (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 44 (1968).

[28] S. 3724, 90th Cong. § 8(d)(1)(A)-(C) (1968), *reprinted in Mutual Fund Legislation of 1967: Hearings on S. 1659 Before the Senate Comm. on Banking and Currency*, 90th Cong. 24 (1967).

[29] S. 3724 instead listed:

> (A) all other compensation or payments paid to such person by such investment company and its security holders as a class; (B) the nature and extent of all services provided to such investment com-

accompanying S. 3724 explaining this deletion, the revised standard incorporated in the bill was "not designed to bring mutual fund management fees, which often cover services other than investment advice, down to the level of investment advisory fees charged in other noncomparable contexts."[30]

The Senate debated S. 3724 and, ultimately, passed the bill. The mutual fund industry, however, opposed the "reasonableness" standard on the grounds that it was tantamount to governmental ratemaking and would be antithetical to investor and industry interests. In September 1968, the bill died in the House when the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce voted not to give it further consideration.

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pany and its security holders as a class by such person in all capacities; and (C) such other factors as are relevant and material under all the circumstances.

Id.

[30] Investment Company Amendments Act of 1968, S. REP. No. 90-1351, at 13 (1968).

3. The 1970 Amendments

In January 1969, Senator Sparkman introduced S. 34 in the new Congress. S. 34 was the same bill—S. 3724—that the Senate had passed the previous year.[31] S. 34 retained the "reasonableness" test for advisory fees, as well as the approach of setting forth a list of factors to be considered in determining reasonableness. It again excluded any comparison with fees charged to other non-fund clients as a specific factor to be considered in determining reasonableness.[32]

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[31] *Investment Company Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong. 7 (1969) (Statement of Hugh F. Owens, Commissioner, SEC).

[32] Like S. 3724, S. 34 listed:

> (A) all other compensation or payments paid to such person by such investment company and its security holders as a class; (B) the nature and extent of all services provided to such investment company and its security holders as a class by such person in all capacities; and (C) such other factors as are relevant and material under all the circumstances.

S. 34, 91st Cong. § 8(d)(1)(A)-(C) (1968), *reprinted in Investment Company Amendments Act of 1969: Analysis of S. 34 Before the Senate Comm. on Banking and Currency*, 91st Cong. 78 (1969).

The mutual fund industry continued to object to the "reasonableness" standard. The industry pointed to the vague nature of the reasonableness test, the prospect of judicial ratemaking that it potentially invited, and inevitable inconsistencies in its application if it were implemented.[33]

While the Senate hearings were ongoing, industry representatives and the SEC conducted negotiations over the terms of the legislation. In April 1969, Senator McIntyre publicly raised the possibility of shifting the approach from a "reasonableness" standard to one imposing a fiduciary duty.[34] This suggestion met with the approval of the mutual fund industry and the SEC, both of which agreed to substitute a fiduciary duty approach for the reasonableness standard.[35]

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[33] *Investment Company Amendments Act of 1969: Hearings on S. 34 and S. 296 Before the Senate Comm. on Banking and Currency*, 91st Cong. 100 (1969) (statement of Robert L. Augenblick, President and General Counsel, Investment Company Institute).

[34] *Id.* at 193-94.

[35] S. 2224, 91st Cong. § 20 (1969), *reprinted in Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. 49-50 (1969). This bill, which was virtually identical to H.R. 11995, became the Investment Company Amendments Act of 1970. Pub. L.

As a result, proposed section 15(d) (containing the reasonableness test first proposed by the SEC in its 1966 Report) was deleted from the legislation. In its place, section 36(b) was inserted, providing that an investment adviser has a "fiduciary duty with respect to the receipt of compensation for services," and likewise providing that, in any action under section 36(b), a court "shall" consider the decision of a fund's board "as is deemed appropriate under all the circumstances."[36] In conjunction with deleting the reasonableness standard, the amended legislation also omitted any reference to any mandatory list of factors to be considered in reviewing advisory contracts.[37]

In May 1969, the amended bill was reported to the full Senate and passed as S. 2224.[38] A virtually identical bill passed the House,[39] and

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No. 91-547, 84 Stat. 1413 (1970) (codified as amended in scattered sections of 15 U.S.C.).

[36] S. 2224, 91st Cong. § 20 (1969), *reprinted in Mutual Fund Amendments: Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 91st Cong. 50-51 (1969).

[37] *Id.* at 44-48.

[38] *See* 116 CONG. REC. S39,124-25 (daily ed. Nov. 30, 1970).

[39] *See* 116 CONG. REC. H39,344-45 (daily ed. Dec. 1, 1970).

thereafter the 1970 Amendments to the ICA were signed into law.

In addition to creating section 36(b), the 1970 amendments also tightened the independence requirements for the "watchdog" members of the board responsible for evaluating and approving advisory contracts. Specifically, the new legislation included new section (2)(a)(19), first proposed in 1967,[40] which added the phrase "interested person" to the statute and defined it more broadly than the older phrase "affiliated person" defined in section 2(a)(3) of the original legislation. The new concept of "interested person" was then substituted for the phrase "affiliated person" in sections 10 and 15 of the Act. As amended, section 10(a) requires that at least 40 percent of a fund's board must consist of individuals who are not "interested persons," and section 15 requires that a majority of the directors who are not "interested persons" must approve the fund's advisory contract.[41]

As the 1969 Senate Report highlighted, "the function [of section 10] with respect to unaf-

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[40] H.R. 9510, 90th Cong. § 2(3) (1967), *reprinted in Investment Company Act Amendments of 1967: Hearings on H.R. 9510 and 9511 Before the Subcomm. on Commerce and Finance of the H. Comm. on Interstate and Foreign Commerce*, 90th Cong. 8 (1968).

[41] 15 U.S.C. §§ 80a-10(a), 80a-15 (2006).

filiated directors is to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs."[42] The report complained that "the definition of an 'affiliated person' in section 2(a)(3) of the [original] act does not adequately meet this purpose."[43] Thus, in order "to remedy the [ICA's] deficiencies in this regard," Congress defined the term "interested person" in section (2)(a)(19) and made use of it in sections 10 and 15.[44]

In order to enhance the board's ability to evaluate advisory contracts, the 1970 amendments also included new provisions in section 15(c) requiring directors to request and consider, and the adviser to provide, "such information as may reasonably be necessary to evaluate the terms of any [advisory] contract . . . ."[45] By mandating this information flow, Congress empowered a board to request and receive a broad

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[42] S. REP. No. 91-184, at 32 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4927.

[43] *Id.*

[44] For example, "interested person" was intended to include persons who were not reached by the term "affiliated person," including persons who have close family or substantial financial or professional relationships with investment companies, their investment advisers, principal underwriters, officers, and employees. *Id.* at 4928.

[45] 15 U.S.C. § 80a-15(c) (2006).

range of materials, including information that might not ordinarily be available in typical commercial negotiations.

Congress further enhanced the board's ability to negotiate advisory contracts by incorporating into new section 36(b) the possibility that a court could review the agreement between the fund and its adviser,[46] specifying that the court would give such consideration to the board's determinations as the court deems "appropriate under all the circumstances."[47] According to the 1969 Senate Report, far from supplanting the role of the board, section 36(b) was "designed to strengthen the ability of the unaffiliated directors to deal with [negotiating advisory fees]."[48]

In short, the 1970 Amendments recognize the critical role that boards, especially independent members, would continue to play in evaluating and approving advisory contracts. As the 1969 Senate Report concluded, "[a] responsible determination regarding the management fee by

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[46] *See* S. REP. No. 91-184, at 7 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4903.

[47] 15 U.S.C. § 80a-35(b)(2) (2006).

[48] S. REP. No. 91-184, at 7 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4903.

the directors including a majority of disinterested directors is not to be ignored."[49]

4. The Purpose and Effects of the 1970 Amendments

Review of the 1970 amendments reveals a constellation of relevant features. The amendments revised sections 10 and 15 to strengthen the independence requirements for boards, and enhanced the board's ability to obtain—indeed required them to obtain—information relevant to the process of reviewing and approving advisory contracts. They also created a special fiduciary duty for the adviser, and authorized a private cause of action incorporating an explicit feature directing consideration of a board's decision to approve the adviser's fees. While these features certainly constitute significant overlays on the original statutory structure, it is evident that, in enacting them, Congress desired to retain the basic premise of the original ICA that decision making over advisory fees is best left in the first instance to a fund's independent directors. Construed in context, these features represent Congress' efforts to enhance the board's ability to negotiate favorable advisory compensation agreements, as in an arms'-length manner, and not to

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[49] *Id.*

prescribe a vehicle for routine second-guessing of a board's determinations.

First, Congress specifically declined to adopt a "reasonableness" standard. Instead, it deemed advisers to have a fiduciary duty with respect to their receipt of compensation. Congress' choice indicates that it did not intend to place in the hands of the courts an objective standard to assess directly the appropriateness of fees, but instead intended to rely on boards to fulfill their role. The function of the courts is therefore to serve as a backstop to board decision making.

Second, Congress declined to enumerate in the statute a list of factors that boards must consider in evaluating and approving advisory contracts. Congress' choice not to tie the board's hands indicates that it wanted boards to retain flexibility in exercising their decision making function to match the needs of their funds, and that there are no particular factors that directors must necessarily consider in approving an adviser's compensation, or that a court must consider in reviewing a board's decision.

Third, by directing courts to give appropriate consideration to a board's decision to approve a particular contract, Congress clearly rejected the idea that independent boards are ineffective in fulfilling their assigned function. Indeed, this

Court has rejected previously the idea that the independent directors of a fund are incapable of fulfilling their assigned role:

> While lack of impartiality may or may not be true as a matter of fact in individual cases, it is not a conclusion of law required by the ICA. Congress surely would not have entrusted such critical functions as approval of advisory contracts and selection of accountants to the statutorily disinterested directors had it shared the...view that such directors could never be 'disinterested' where their codirectors or investment advisers were concerned.[50]

As the Court has also observed, "when by 1970 it appeared that the 'affiliated person' provision of the 1940 Act might not be adequately restraining conflicts of interest, Congress turned not to direct controls, but rather to stiffening the requirement of [director] independence as the way to 'remedy the act's deficiencies.'"[51]

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[50] *Burks v. Lasker*, 441 U.S. 471, 485 n.15 (1979).

[51] *Id.* at 484 (quoting S. REP. No. 91-184, at 32-33 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4928).

On the issue of how section 36(b) should be applied, it is evident that Congress also did not require, and did not intend, that any single factor would be outcome determinative. Certainly it cannot be argued credibly that a factor proposed and eliminated early on by Congress—namely, the comparison of the fees charged under the advisory contract with the fees the adviser charged to other non-mutual fund clients—should be the central or dispositive factor in the board's or a court's determination.

Likewise, section 36(b) was "not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors in the area of management fees."[52] As the 1969 Senate Report provides, section 36(b) "is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary,"[53] or to authorize the judiciary to set rates, or impose a "cost-plus" type of contract.[54]

Rather, just as the legislative scheme suggests, the relevant approach should be one

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[52] S. REP. No. 91-184, at 6 (1969), *as reprinted in* 1970 U.S.C.C.A.N. 4897, 4902.

[53] *Id.* at 4903.

[54] *Id.* at 4902.

whereby a court ordinarily will defer to the decision of a board to approve an advisory contract unless the court has a compelling reason not to defer. This approach is consistent with Congress' evident intent to rely on board approval in the first instance to determine the appropriateness of an adviser's fees, and likewise the elaborate safeguards that Congress put in place to ensure responsible decision making. Only in this way can the board's function receive the consideration that Congress intended it to have.

B. The Enhanced Independence of Mutual Fund Boards under SEC and Industry Guidance and Application of the Deference Principle

Following the enactment of section 36(b) in 1970, the history of the role of independent mutual fund directors in the evaluation and approval of advisory contracts has been one of expanding responsibility. Review of this history at the regulatory level lends further support to the conclusion that, absent unusual circumstances, a court reviewing a claim under section 36(b) should defer to directorial approval of an adviser's contractual compensation. Although the regulatory history extends across many years, the Forum highlights here developments most relevant to the issues presently before the Court.

In early 1999, the SEC held a "Roundtable" on the role of independent investment company directors.[55] As explained by Arthur Levitt, then Chairman of the SEC, the purpose of the Roundtable was to discuss "the increasingly important role that independent directors play in protecting fund investors, and precisely how their effectiveness may be enhanced."[56] The participants of the Roundtable included independent directors, investor advocates, executives of fund advisers, academics, and experienced legal counsel.

In October 1999, in response to the recommendations made at the Roundtable, and after its own review, the SEC issued a release entitled "Role of Independent Directors of Investment Companies"[57] along with a companion in-

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[55] *The Role of Independent Investment Co. Directors, Transcript of the Conference on the Role of Independent Investment Co. Directors*, SEC (Feb. 23-24, 1999), *available at* http://www.sec.gov//divisions/investment/roundtable/iicdtoc.shtml.

[56] *The Role of Independent Investment Co. Directors, Transcript of the Conference on the Role of Independent Investment Co. Directors*, SEC (Feb. 23, 1999), http://www.sec.gov/divisions/investment/roundtable/iicdrndt1.htm#valua (statement of Chairman Levitt).

[57] Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 64 Fed. Reg. 59,826 (proposed Nov. 3, 1999).

terpretive release.[58] Together, these releases were designed "to reaffirm the important role that independent directors play in protecting fund investors, strengthen their hand in dealing with fund management, [and] reinforce their independence..."[59]

As a further result of the Roundtable, and in order to enhance the independence and effectiveness of independent directors, the SEC also proposed to amend and, on January 2, 2001 did amend,[60] ten exemptive rules under the ICA[61] to require investment companies that rely on those exemptive rules (which virtually all do) (1) to have at least a majority of their board consist of independent directors; (2) to have the independent directors select and nominate other inde-

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[58] Interpretive Matters Concerning Independent Directors of Investment Companies, Investment Company Act Release No. 24,083, 64 Fed. Reg. 59,877 (Nov. 3, 1999).

[59] Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 64 Fed. Reg. 59,826, 59,827 (proposed Nov. 3, 1999).

[60] Role of Independent Directors of Investment Companies, Securities Act Release No. 7932, Exchange Act Release No. 43,786, Investment Company Act Release No. 24,816, 66 Fed. Reg. 3734 (Jan. 16, 2001).

[61] *See id.*; 17 C.F.R. §§ 270.10f-3, 270.12b-1, 270.15a-4(b)(2), 270.17a-7, 270.17a-8, 270.17d-1(d)(7), 270.17e-1, 270.17g-1(j), 270.18f-3, 270.23c-3 (2006).

pendent directors; and (3) to require that independent directors' counsel be independent.[62]

Regarding the first requirement, the SEC opined that "a fund board that has at least a majority of independent directors is better equipped to perform its responsibilities of monitoring potential conflicts of interests and protecting the fund and its shareholders."[63] As the Commission explained further, "[b]y virtue of its independence, and its ability to act without the approval of the investment adviser...such a board is better able to exert a strong and independent influence over fund management."[64]

With regard to the second requirement, the SEC stated that "[i]ndependent directors who are selected and nominated by other independent directors, rather than by the fund's adviser, are more likely to have their primary loyalty to shareholders rather than the adviser."[65] As the SEC added, "when independent directors are self-selecting and self-nominating, they are less

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[62] Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 64 Fed. Reg. 59,826 (proposed Nov. 3, 1999).

[63] *Id.* at 59,830.

[64] *Id.*

[65] *Id.* at 59,832.

likely to feel beholden to the adviser."[66] As the Commission concluded, "[t]hus, they may be more willing to challenge the adviser's recommendations when the adviser's interests conflict with those of the shareholders."[67]

Explaining the third requirement, the SEC commented that "[b]ecause mutual funds are highly regulated and their boards frequently are called upon to protect fund shareholders from conflicts of interest, independent counsel can be particularly helpful to independent directors of funds."[68] As the SEC reasoned, "[e]xperienced counsel can help to identify potential conflicts of interest and other compliance issues."[69] The Commission observed further that courts have also recognized the importance of independent counsel to independent directors in determining how much weight to give a board's determination to approve an advisory contract.[70]

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[66] *Id.*

[67] *Id.*

[68] Role of Independent Directors of Investment Companies, Securities Act Release No. 7754, Exchange Act Release No. 42,007, Investment Company Act Release No. 24,082, 64 Fed. Reg. 59,826, 59,833 (proposed Nov. 3, 1999).

[69] *Id.*

[70] *Id.*; *see also, e.g., Tannenbaum v. Zeller*, 552 F.2d 402, 428 (2d Cir. 1977); *Fogel v. Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975).

Because virtually all funds rely on at least one of the exemptive rules, they are all effectively required to adopt each of these heightened independence features. In addition, the SEC has also required mutual funds to have a Chief Compliance Officer, who provides the board with an independent source of information and insight about the fund's and the adviser's operations.[71] As a result of these regulatory initiatives, the independence of boards has only increased over time, further facilitating Congress' scheme and reinforcing the principle that courts should ordinarily defer to directorial approval of advisory contracts.

Industry resources have also been used to support and educate independent directors. The Forum itself conducts educational workshops and conferences, and provides on-line news, information, and publications to assist independent directors in fulfilling their duties. The Forum's 2004 whitepaper on board "best practices," which includes an extensive discussion and analysis of advisory contract reviews, is a document widely consulted and relied upon within

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[71] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Advisers Act Release No. 2204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74,714, 74,721 (Dec. 24, 2003).

the industry.[72] The SEC and others have recognized the importance of the Forum's role. Speaking at the first Policy Conference held by the Forum after its formal organization, then SEC Chairman Harvey L. Pitt stated: "Mutual fund investors benefit from groups like the Forum that seek to improve and elevate fund governance, and promote the development of vigilant, dedicated and well-informed independent directors."[73]

Similarly, the industry itself has taken steps to "strongly support[] enhancement of the standards for, and the role of, independent directors."[74] Notably, for example, the industry's trade organization, the Investment Company In-

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[72] Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* (July 2004); *see also* Letter from William H. Donaldson, Chairman, SEC, to David S. Ruder & Allan S. Mostoff, Mutual Fund Directors Forum (Nov. 17, 2003), *in* Mutual Fund Directors Forum, *Best Practices and Practical Guidance for Mutual Fund Directors* 40-41 (July 2004) (SEC Chairman Donaldson "call[ing] upon the [Forum] to develop guidance and best practices in areas where director oversight and decision-making is critical for the protection of fund shareholders").

[73] Harvey L. Pitt, Chairman, SEC, *Remarks at Mutual Fund Directors Forum* (Jan. 8, 2003), http://www.sec.gov/news/speech/spch010803hlp.htm.

[74] Richard M. Phillips, *Mutual Fund Independent Directors: A Model for Corporate America?*, 9 ICI PERSPECTIVE 1, 3 (Aug. 2003).

stitute, has recognized the importance of independent boards, establishing within its membership the Independent Directors Council, a subgroup dedicated to the needs of independent directors and the advancement of sound industry practices.

The SEC and the industry have taken substantial steps over the years to enhance the ability of a board's independent directors to engage in robust, effective evaluations of advisory contracts. This supports the principle that, absent unusual circumstances, the board's approval of an adviser's fees is entitled to deference under the provisions of section 36(b).

In determining whether a board's evaluation and approval of a particular advisory contract has in fact been conducted in an ordinary, responsible fashion (and is thus deserving of deference), or whether unusual circumstances exist warranting setting the board's decision aside, both the courts and the SEC have likewise provided essential guidance. For example, in the seminal case *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*,[75] the Court of Appeals for the Second Circuit highlighted the central role of a fund's board in approving advisory contracts, and adopted a standard that defers to and pro-

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[75] 694 F.2d 923 (2d Cir. 1982).

tects that function when exercised responsibly. The court held that, to be guilty of a violation of section 36(b), the adviser "must charge a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining."[76] The court also identified several factors that courts should consider in reviewing cases brought under section 36(b). Among these factors—and expressly singled out by the court of appeals as important—were "the expertise of the independent trustees of a fund, whether they are fully informed about all facts bearing on the adviser-manager's service and fee, and the extent of care and conscientiousness with which they perform their duties."[77]

The *Gartenberg* decision has the correct view of the role of the board. Not only is it consistent with the statutory text, it is faithful to the purposes behind it.

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[76] *Id.* at 928.

[77] *Id.* at 930. *Gartenberg* further identified other factors as potentially relevant to whether a board properly evaluated an advisory contract, including: (1) the adviser's cost in providing its services to the fund; (2) the nature and quality of its services; and (3) the extent to which the adviser realizes economies of scale as the fund grows larger. *Id.* at 929-30.

Subsequently, in a 2004 Release the SEC recognized factors similar to those listed in *Gartenberg* that boards typically consider.[78] In its release, the SEC issued rules governing disclosure requirements in fund shareholder reports and proxy statements regarding board approval of advisory contracts. The SEC determined that the following "specific factors" were especially important for boards to consider when analyzing an advisory contract:

> The amendments will require a fund to include a discussion including, but not limited to, the following: (1) the nature, extent, and quality of the services to be provided by the investment adviser; (2) the investment performance of the fund and the investment adviser; (3) the costs of the services to be provided and profits to be realized by the investment adviser and its affiliates from the relationship with the fund; (4) the extent to which economies of scale would be realized as the fund grows; and (5)

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[78] Disclosure Regarding Approval of Investment Advisory Contracts by Directors of Investment Companies, Securities Act Release No. 8433, Exchange Act Release No. 49,909, Investment Company Act Release No. 26,486, 69 Fed. Reg. 39,798 (Jun. 30, 2004).

> whether fee levels reflect these economies of scale for the benefit of fund investors.[79]

Regarding any comparison between the fees an adviser charges a mutual fund and the fees the adviser charges other non-mutual fund clients, the 2004 Release contained the following statement:

> *Comparison of Fees and Services Provided by Adviser.* The fund's discussion will be required to indicate *whether* the board relied upon comparisons of the services to be rendered and the amounts to be paid under the contract with those under other investment advisory contracts, such as contracts of the same and other investment advisers with other registered investment companies or other types of clients (*e.g.*, pension funds and other institutional investors). If the board relied upon such comparisons, the discussion will be required to describe the comparisons that were relied on and how they assisted the board in concluding

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[79] *Id.* at 39,801.

> that the contract should be approved.[80]

Notably, the amended disclosure requirements implemented by the release do not *require* this kind of comparison. Rather, they merely provide that, if the board in its discretion conducts the comparison, that fact must be disclosed.

Where a board has actively sought and obtained the information directed by section 15(c), and has actively evaluated the merits of the advisory contract addressing the factors prescribed by the SEC, the board's decision to approve the contract is entitled to deference under section 36(b) absent a compelling demonstration that the adviser materially misled the board or that deference is unwarranted owing to other unusual circumstances. Absent such a compelling demonstration, the board's decision should be conclusive. In this case, the lower courts observed that there appears to be no contention that the board neglected its duties or was materially deceived. Accordingly, the board's decision to approve the advisory contract is entitled to deference.

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[80] *Id.* at 39,801-02 (emphasis supplied).

CONCLUSION

The judgment of the Seventh Circuit affirming the District Court should be affirmed.

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AMICUS CURIAE BRIEF

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(8)

No. 08-586

Supreme Court, U.S.
FILED
JUN 17 2009
OFFICE OF THE CLERK

In The

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLINE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES, L.P.,

Respondent.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF OF *AMICUS CURIAE* NATIONAL ASSOCIATION OF SHAREHOLDER AND CONSUMER ATTORNEYS (NASCAT) IN SUPPORT OF PETITIONERS

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INTEREST OF *AMICUS CURIAE* NASCAT[1]

The National Association of Shareholder and Consumer Attorneys (NASCAT) is a nonprofit membership organization. Founded in 1988, its members are law firms committed to the vigorous prosecution of corporate fraud. NASCAT is a trade organization and public policy voice for lawyers interested in a strong system of federal and state legal protections for investors and consumers. Acting through its Amicus Committee, NASCAT has filed more than two dozen *amicus curiae* briefs in the United States Supreme Court, federal circuit courts of appeal, and state supreme courts in cases involving federal and state securities, antitrust, civil racketeering, and consumer protection law.

In this instance, NASCAT represents the voice of the mutual fund shareholders in the face of a well-organized and powerful mutual fund lobby. It is these shareholders whose investments are at stake here. In 2008, an estimated 92 million individual investors representing 45 percent of all U.S. households owned mutual funds and held 82 percent of total mutual

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[1] No counsel for any party has authored this brief in whole or in part, and no person or entity other than *amicus curiae* had made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.6. Counsel for Petitioners filed a letter with the Clerk granting blanket consent to the filing of *amicus* briefs, and a letter reflecting the consent of Respondent to the filing of this brief has been filed with this brief. *See* Sup. Ct. R. 37.3.

fund assets by year-end. Inv. Co. Inst., 2009 Mutual Fund Fact Book, Section 6 (49th ed. 2009), *available at* http://www.ici.org/pdf/2004_factbook.pdf. This case is of paramount importance to those investors evaluating mutual funds as it will represent the first decision by this Court regarding the standard for adviser compensation under Section 36(b) of the Investment Company Act (the "ICA"). As already recognized by this Court, Section 36(b) is a crucial component of Congress's effort to protect mutual fund investors against abuse and overreaching by the advisers that hold their mutual funds captive.

SUMMARY OF ARGUMENT

In 1940, Congress enacted the ICA (15 U.S.C. §80a-1 et seq.) due to "its concern with 'the potential for abuse inherent in the structure of investment companies.'" *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 536 (1984) (*citing Burks v. Lasker*, 441 U.S. 471, 480 (1979)). As applied by the courts, however, the version of Section 36 enacted at that time provided insufficient redress for mutual fund investors as it required them to demonstrate a "gross abuse of trust" on the adviser's part to obtain relief under the statute. Realizing that existing standards did not adequately address that "the forces of arm's length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy" (S. Rep. No. 91-184, at 5 (1969),

reprinted in 1970 U.S.C.C.A.N. 4897, 4901), Congress enacted Section 36(b) of the ICA in 1970.

Investors' ability to effectively prosecute claims under Section 36(b) is an essential component of any meaningful effort to police excessive advisory fees. As both Congress and this Court have recognized, Section 36(b) is necessary because the approval of fees by the funds' unaffiliated directors is not enough on its own to assure that the fees are the equivalent of those that would be charged if arm's-length bargaining had taken place. As discussed below, this unfortunate reality has repeatedly been demonstrated in litigation under Section 36(b) as well as in other cases in which the adequacy of the unaffiliated directors' representation of mutual fund interests was at issue. Among its benefits, Section 36(b) litigation can provide needed transparency with respect to the fee approval process of information which advisers normally hide from public view.

Despite all of the potential benefits of such litigation, mutual funds and their investors have been unable to get much relief from Section 36(b) actions as a result of decades of a misapplied standard under Section 36(b). Although *Gartenberg v. Merrill Lynch Asset Management*, 694 F.2d 923 (2d Cir. 1982) correctly included "arm's-length bargaining" as part of the standard governing Section 36(b), it also employed a standard requiring the compensation to be "disproportionately large" in relation to the value of the services which subsequent courts have effectively converted into a corporate

waste requirement. The Seventh Circuit below in *Jones v. Harris Associates, L.P.*, 527 F.3d 627 (7th Cir. 2008) further limited Section 36(b) by applying an extremely narrow interpretation of fiduciary duty tantamount to requiring that plaintiffs show fraudulent behavior on the adviser's part. Neither of these approaches fulfills Congress's goal of making Section 36(b) a vehicle through which funds and their investors can ensure that the fees charged will be consistent with what would have resulted from arm's-length bargaining. *Amicus* NASCAT submits that this Court should reject both these standards. The Eighth Circuit in *Gallus v. Ameriprise Finance, Inc.*, 561 F.3d 816 (8th Cir. 2009), has set forth an approach consistent with what Congress required by giving consideration to both the fairness of the fee charged and the adequacy of disclosure by the adviser to the unaffiliated directors. *Amicus* NASCAT respectfully submits that the *Gallus* standard be given consideration by this Court.

ARGUMENT

I. LITIGATION UNDER SECTION 36(b) IS A CRUCIAL MEANS OF PROTECTING MUTUAL FUNDS AGAINST THE LACK OF ARM'S-LENGTH BARGAINING AND CONFLICTS OF INTEREST THAT CHARACTERIZE THE MUTUAL FUND-ADVISER RELATIONSHIP

Before Congress enacted Section 36(b) in 1970, existing legal remedies were insufficient to protect

mutual funds and their shareholders against the consequences of conflicts of interest between funds and their advisers, and a consequent lack of arm's-length bargaining. Courts subjected legal challenges to investment advisory fees to the nearly insurmountable "gross abuse of trust" and "corporate waste" standards, under which fees had to be "unconscionable." *See Fox*, 464 U.S. at 540 & n.12. Eventually, Congress took notice of the hurdles plaintiffs were facing and passed Section 36(b), which implemented the "fiduciary duty" standard that exists today.[2]

There are numerous reasons why shareholder litigation under Section 36(b) is vital to encourage the equivalence of arm's-length negotiation and to provide relief where such negotiation does not occur.[3] First, the unaffiliated directors' approval is often not enough to ensure that the fees charged to the funds will be consistent with what would have resulted from arm's-length bargaining. As this Court explained in *Fox*: "Congress decided not to rely solely on the fund's directors to assure reasonable adviser fees, notwithstanding the increased disinterestedness of

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[2] Section 36(b) imposes on investment advisers "a fiduciary duty with respect to the receipt of compensation for services." 15 U.S.C. §80a-35(b).

[3] This Court itself has commented on the importance of effective enforcement of investors' rights through private litigation. *See Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 313 (2007).

the board." *Fox,* 464 U.S. at 540. Instead, Congress mandated that director approval should be afforded only "such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. §80a-35(b)(2). Thus, Congress provided a private right of action in Section 36(b) to complement director approval of advisory contracts.

Moreover, although the SEC has stated that "the best way to ensure [fair and reasonable fees] is a marketplace of vigorous, independent, and diligent mutual fund boards coupled with fully-informed investors," (Statement of the Commission Regarding the Enforcement Action Against Alliance Capital Management, L.P., SEC Press Release 2003-176 (Dec. 18, 2003)), fund boards have failed to fulfill this role, primarily because the so-called "independent" directors, who are supposed to be the "watchdogs" of the funds, are often not truly independent of the adviser. *See Burks,* 441 U.S. at 485. This fact has been recognized, for example, in the following comment made by Warren Buffet (famous investor and chairman of Berkshire Hathaway) as quoted by a United States District Court:

> I think independent directors have been anything but independent. The Investment Company Act, in 1940, made these provisions for independent directors on the theory that they would be the watchdogs for all these people pooling their money. The behavior of independent directors in aggregate since 1940 has been to rubber stamp every deal

> that's come along from management – whether management was good, bad, or indifferent. Not negotiate for fee reductions and so on. A long time ago, an attorney said that in selecting directors, the management companies were looking for Cocker Spaniels and not Dobermans. I'd say they found a lot of Cocker Spaniels out there.

Strougo v. BEA Assoc., 188 F. Supp. 2d 373, 383 (S.D.N.Y. 2002) (citation omitted).

The SEC has also recognized that "many boards continue to be dominated by their management companies." Investment Company Governance, Investment Company Act Release No. 26,520, 69 Fed. Reg. 46,378, 46,381 (July 27, 2004). This is so because, as this Court has explained, "unlike most corporations, [a mutual fund] is typically created and managed by a pre-existing external organization known as an investment adviser . . . [that] often selects affiliated persons to serve on the [fund's] board of directors. . . ." *See Fox*, 464 U.S. at 536.

The frequent submission of purportedly "independent" fund directors to the will of the adviser is starkly demonstrated by the fact that "while independent fund directors have the right to demand advisory or distribution fee cuts or to fire the fund's adviser or underwriter, those rights are virtually never exercised." John P. Freeman & Stewart L. Brown, *Mutual Fund Advisory Fees: The Cost of Conflicts of Interest*, 26 Iowa J. Corp. L. 609, 617 (2001). This domination can result in the directors

assuming a passive role in the fee approval process by not aggressively seeking full information from the adviser or conducting an otherwise serious and dispassionate review of the adviser's presentation to the directors. A sophisticated understanding of the fees the directors must approve requires a great deal of information that the unaffiliated directors will not have unless the adviser voluntarily provides it to them or they ask for it, which they often fail to do. This passivity thus limits the "independent" directors' ability to properly oversee the fees charged to the funds.

The need for continued vigilance with respect to advisers' abuse of their relationships with mutual funds has been amply demonstrated in litigation under Section 36(b) and other provisions of the ICA. For example, in *Galfand v. Chestnutt Corp.*, 545 F.2d 807, 812 (2d Cir. 1976), the Second Circuit held that the adviser had "ignored completely his duty to promote responsible directorial judgment by supplying information sufficient to enable the fund's [board of directors] to evaluate the new contract," resulting in "a patently one-sided revision of the advisory contract." *Id.* at 809. In *Moses v. Burgin*, 445 F.2d 369, 372 (1st Cir. 1971), a case under Section 36 of the 1940 ICA arising prior to Section 36(b)'s enactment, an adviser failed to disclose to the fund's directors that some of the brokerage commissions being paid by the funds might be able to be "recaptured" and credited against its advisory fees. Even under the "gross abuse of trust" standard

applied before the passage of Section 36(b), the First Circuit held that the adviser breached its fiduciary duty by failing to fully disclose to the directors the information available to it. *Id.* at 384; *see also Papilsky v. Berndt*, No. 71 Civ. 2534, 1976 U.S. Dist. LEXIS 14442, at *43-44 (S.D.N.Y. June 24, 1976) (imposing liability on an adviser for breach of fiduciary duty under the ICA for failing in its duty of full disclosure with respect to recapturing brokerage commissions and stating, "[t]he effective performance of this crucial watchdog role depends on the flow of information to these [unaffiliated] directors from the affiliated directors.").[4]

Indeed, the mutual fund industry has been pervasively characterized by shareholder abuses. In recent years, lawsuits instituted by private litigants, the SEC, and state regulators have uncovered swaths of industry-wide wrongdoing with respect to revenue sharing, directed brokerage, market timing and late trading that took place on the watch of the not-so-vigilant fund directors. *See, e.g.*, William A. Birdthistle, *Compensating Power: An Analysis of Rents and Rewards in the Mutual Fund Industry*, 80 Tul. L. Rev. 1401, 1405-07 (2006). Such litigations have generated substantial benefits for mutual funds

[4] The facts of the case at bar vividly illustrate this point as they strongly support a conclusion that the relationship between the adviser and the unaffiliated directors was not one in which the interests of the mutual funds were being adequately protected.

and their shareholders through agreements to reduce advisory fee schedules. For example, on December 18, 2003, in order to settle the market timing case brought by the New York State Office of the Attorney General ("NYAG"), adviser Alliance Capital Management agreed to an advisory fee reduction over five years of approximately $350 million. *See* Assurance of Discontinuance Pursuant to Executive Law §63(15), *In re Alliance Capital Management, L.P.*, Att'y Gen. of N.Y. Bureau of Inv. Prot. at 23-24 (Aug. 19, 2004), *available at* http://www.oag.state.ny.us/bureaus/investor_protection/investors/alliance_cap_mgmt_aod.pdf. As another example, defendants in *In re Columbia Entities Litigation*, CV 04-11704 (D. Mass. Jan. 19, 2007), an action brought by private litigants under Section 36(b), acknowledged in their settlement agreement that the Section 36(b) litigation was a factor in their implementation of advisory fee breakpoints, as well as enhanced shareholder communications and reduced "soft dollar" spending. *See* Stipulation and Settlement Agreement at 11, paragraphs 5.2(a)-(c).

Finally, shareholder litigation under Section 36(b) is important because of the enforced transparency it can provide, as the inner workings of the mutual fund industry are shrouded in secrecy. Advisers and directors closely guard the details of fund board deliberations regarding fees and what information the fund boards request and receive. As a result, mutual fund shareholders receive little

information regarding the process of how and why the fees were approved.

Because the information underlying the fee approval processes is kept from the public, governmental bodies such as the SEC have acknowledged that even they have trouble acquiring the economic data from advisers relevant to evaluating the fairness of advisers' fees. *See* discussion at 14-15, *infra*. Section 36(b) litigation that makes it through to summary judgment stage or trial results in a court opinion from which the public with some meaningful information about the realities of what transpired during the fee approval process.[5]

II. COURTS HAVE ERRONEOUSLY EVISCERATED THE "ARM'S-LENGTH BARGAINING" STANDARD THAT GOVERNS ADVISER COMPENSATION UNDER SECTION 36(b)

As discussed at length in Petitioner's brief, in employing the phrase "fiduciary duty" in Section

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[5] The importance of an effective remedy under Section 36(b) became even greater as certain courts ruled that ICA Sections 15(a), 15(c) and 36(a) do not provide implied private rights of action for excessive fees. *See Tarlov v. Paine Weber Cashfund, Inc.*, 559 F. Supp. 429 (D. Conn. 1983) (no private right of action under Section 15(a)); *Halligan v. Standard & Poor's/Intercapital, Inc.*, 434 F. Supp. 1082, 1084 (E.D.N.Y. 1977) (no private right of action under Section 15(c)). *See* Lyman Johnson, *A Fresh Look at Director "Independence": Mutual Fund Fee Litigation and Gartenberg at Twenty-Five*, 61 Vand. L. Rev. 497, 510 (2008).

36(b), Congress incorporated the familiar common-law principles that phrase embodies. Brief for Petitioners dated June 10th, at 20-29. This Court has held that the fiduciary must act in "good faith," and the transaction must be "fair[ ] from the viewpoint of the" beneficiary. *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939). "The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's-length bargain." *Id.*

The leading case interpreting Section 36(b) at this juncture is *Gartenberg*, 694 F.2d 923. *Gartenberg* embraced traditional fiduciary duty principles by correctly holding that advisers violate their fiduciary duty under Section 36(b) when they charge fees that exceed what they could have obtained in an actual arm's-length transaction.[6] But *Gartenberg*, as interpreted and applied in subsequent decisions, is flawed. The first problem with the *Gartenberg* decision is that it also required that the fee must be "so disproportionately large that it bears no reasonable relationship to the services rendered" for an adviser to breach its fiduciary duty under Section 36(b). *See* 694 F.2d at 928. As interpreted and applied in

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[6] The district court in *Gartenberg* had relied upon *Galfand*, 545 F.2d 807, when determining the fiduciary standard upon which the adviser's compensation would be weighed. *See Gartenberg v. Merrill Lynch Asset Management, Inc.*, 528 F. Supp. 1038, 1047 (S.D.N.Y. 1981) (quoting *Galfand*: "The conduct of the investment adviser must be governed by the 'duty of uncompromising fidelity' and 'undivided loyalty' to the Fund's shareholders that is imposed by Section 36(b).").

subsequent decisions by other courts, the "so disproportionately large" language places a higher burden on plaintiffs than that which exists under the law of fiduciaries[7], and appears similar to the corporate waste approach Congress rejected in enacting Section 36(b). *See* John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 129 (2008).

In part, this regression to the pre-enactment standard has been accomplished through various courts' rigid application of the so-called "*Gartenberg* factors." In *Gartenberg*, although the Second Circuit acknowledged that courts must consider "all of the surrounding circumstances" in determining whether the fee is comparable to an arm's-length bargain, it then enumerated six factors that must be weighed to determine whether a fee violated Section 36(b). 694 F.2d at 928. Subsequent court decisions have erroneously interpreted the *Gartenberg* factors as a checklist of evidence that investors must satisfy in order to meet their Section 36(b) burden. *See, e.g., Krinsk v. Fund Asset Mgmt., Inc.*, 875 F. 2d 404 (2d

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[7] *See Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928) ("Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.").

Cir. 1989). Some of these evidentiary requirements are extremely burdensome and difficult to prove.

For example, one of the *Gartenberg* factors is the fund's profitability to the adviser. To calculate profits, an investor must obtain data regarding the adviser's cost of providing services to the fund – data advisers fight to keep hidden from the public. As one commentator explained:

> Indeed, some years ago, the SEC's Chief Economist was asked about seeking to collect industry-wide data on fund advisory firms' revenue, costs, and profitability. He responded: "As to your suggestion that the SEC's Chief Economist do a revenue/cost/profit study, I know I'd be interested, but I don't think the industry would oblige us." To even start a profitability analysis, a plaintiff must marshal evidence the SEC itself does not have and says it cannot obtain . . .
>
> Next, even if the raw data is found, profitability calculations involve cost allocation issues that are subject to dispute, and there is no universally accepted methodology for making the analysis. This means that, in practice, profitability is bitterly contested. Recall that in *Gartenberg*, the experts' analysis of the advisers' profitability left the court in doubt whether the adviser had enjoyed a lush profit margin in 1980 of 38% or more or had suffered a loss . . . Given that profitability data is hidden, subject to fierce dispute once found, and next to impossible for courts to analyze, it is unclear what is

> gained by making proof about the adviser's profitability a criterion for recovery in cases attacking advisory fees.

John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 Okla. L. Rev. 83, 131-32 (2008).

The difficulty in obtaining cost data also makes it difficult for investors to offer evidence regarding the *Gartenberg* factor of whether the adviser experienced economies of scale. By contrast, probative information regarding fees charged to institutional accounts is often a matter of public record and in any event is easy to obtain in discovery. Unlike issues concerning profitability or economies of scale, the fees actually charged to such institutions as compared with fees charged to retail investors is not subject to dispute.

Indeed, the "disproportionately large" standard coupled with a rigid application of the *Gartenberg* factors has made it nearly impossible for investors to recover excessive fees charged by investment advisers. Not a single investor has won at trial since courts started employing the *Gartenberg* standard. As one commentator noted:

> Fund managers' unblemished, thirty-seven year record of success is all the more remarkable considering that a section 36(b) plaintiff need only prove the violation of a fiduciary duty, a presumably far less demanding hurdle than in many comparable types of claims.

Mercer E. Bullard, *Dura, Loss Causation, and Mutual Funds: A Requiem for Private Claims?*, 76 U. Cin. L. Rev. 559, 560 n.5 (2008) (*citing Acampora v. Birkland*, 220 F. Supp. 527, 549 (D. Colo. 1963) (requiring for state law excessive fees claim that plaintiffs show that fees were "unconscionable and shocking")).

Although the application of *Gartenberg's* "disproportionately large" standard and the "*Gartenberg* factors" have effectively neutered Section 36(b), *Gartenberg* nonetheless set forth the correct "arm's-length bargaining" standard. In contrast, the Seventh Circuit in the instant case went too far in eschewing *Gartenberg* in its entirety in exchange for a standard that requires trickery on the part of the adviser and a truncated duty of disclosure. In so doing, the Seventh Circuit ignored the fiduciary requirement of "fairness" that exists independently of the adequacy of disclosure. Moreover, by reducing the standard under Section 36(b) to "an adviser must play no tricks," the Seventh Circuit has essentially required that investors prove fraud to succeed on their Section 36(b) claim – something Congress undoubtedly did not contemplate when it replaced the "gross abuse of trust" standard with a standard based on common law fiduciary duties.

The Eighth Circuit's recent decision in *Gallus*, 561 F.3d 816, represents the best approach to date – one that reconciles the *Gartenberg* standard with what is required under common law fiduciary duty standards. *Gallus* held that proving that the fee itself was so high it must be excessive is one way, but not

the only way, a plaintiff can prove a breach of fiduciary duty under Section 36(b). *Id.* at 823. The Eighth Circuit explained that another way for a plaintiff to show a breach of fiduciary duty under Section 36(b) would be to demonstrate that the adviser was not "honest and transparent throughout the negotiation process" and for the court to look to "both the adviser's conduct during negotiation and the end result." *Id. Gallus* is only the latest in a line of Section 36(b) cases which hold that advisers and their affiliates are governed by traditional fiduciary duty principles that are not limited to the factors specified in *Gartenberg*. *See, e.g., Galfand*, 545 F.2d at 809; *In re Mut. Funds Inv. Litig.*, 590 F. Supp. 2d 741 (D. Md. 2008). This approach is consistent with the statute's express focus on fiduciary responsibilities and more meaningfully protects funds and their shareholders from the conflicts of interest inherent in the adviser's relationship with the fund.

CONCLUSION

Congress enacted Section 36(b) and its "breach of fiduciary duty" standard to afford greater rights to mutual funds and their investors. Since its enactment, however, courts, including the Seventh Circuit in this case, have applied Section 36(b) in a way that largely prevents redress under that statute. This Court should therefore reverse the Seventh Circuit below and require the courts to apply the fiduciary

duty standard of Section 36(b) that Congress intended.

Respectfully submitted,

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June 17, 2009

AMICUS CURIAE BRIEF

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(10)

Supreme Court, U.S.
FILED
JUN 17 2009
OFFICE OF THE CLERK

No. 08-586

In The
Supreme Court of the United States

JERRY N. JONES, *ET AL.*,

Petitioners,

v.

HARRIS ASSOCIATES, L.P.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICUS CURIAE*[1]

The North American Securities Administrators Association, Inc. ("NASAA"), is the nonprofit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has 67 members, including the securities regulators in all 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, it is the oldest international organization devoted to protecting investors from fraud and abuse in the offer and sale of securities and investment advice.

State securities regulators collectively initiate thousands of enforcement actions each year against broker-dealers and investment advisers who violate the securities laws. *See* NASAA Enforcement Statistics, http://www.nasaa.org/issues__answers/enforcement___legal_activity/1002.cfm. Some of the states' most significant cases have been aimed at curbing systemic abuses in the mutual fund industry, including late trading, market timing, and undisclosed shelf-space agreements. *See, e.g.*, Press Release, Office of N.Y. State Att'y Gen., State Investigation Reveals Mutual Fund Fraud (Sept. 3, 2003), *available at* http://www.oag.state.ny.us/media_center/2003/sep/sep03a_03.html; *Capital Research & Mgmt. Co. v.*

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[1] A letter from counsel for Petitioners granting blanket consent to the filing of *amici curiae* briefs was docketed on May 22, 2009, and written consent from counsel for Respondent has been filed with this brief. No counsel for a party authored this brief in whole or in part, nor did any person or entity, other than the *amicus curiae*, its members, or its counsel, make a monetary contribution intended to fund the preparation or submission of this brief.

Brown, 147 Cal. App. 4th 58 (Cal. Ct. App. 2007) (holding that federal law did not preempt California's enforcement action for failure of investment adviser and broker-dealer to disclose shelf-space agreements).

Recognizing that private actions are an essential complement to governmental enforcement of the securities laws, NASAA and its members also support the rights of investors to seek redress in court for investment-related fraud and abuse. *See, e.g.*, Brief of N. Am. Sec. Admins. Assoc., Inc. as Amicus Curiae in Support of Petitioner, *Stoneridge Inv. Partners v. Scientific-Atlanta, Inc.*, 522 U.S. 148 (2008) (No. 06-43), *available at* http://www.nasaa.org/content/Files/Amicus_Stoneridge.pdf (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 230-31 (1988) (the private cause of action constitutes "an essential tool for enforcement of the 1934 Act's requirements")).

NASAA and its members have an interest in this appeal because the Court's decision will profoundly affect the ability of millions of mutual fund investors to protect themselves from investment advisers who extract exorbitant fees from the captive funds they manage. The Petitioners allege that the Respondent is violating its fiduciary duty under Section 36(b) of the Investment Company Act of 1940 ("ICA"), as amended, by charging inflated advisory fees. 15 U.S.C. § 80a-35(b) (2006). This form of abuse has been widespread in the mutual fund industry for decades. It harms millions of Americans, the majority of whom are Main Street investors. In 2008, approximately 92 million individuals, representing 52.5 million households, held over $10 trillion in mutual funds. Inv. Co. Inst., 2009 Inv. Co. Fact Book 11, 76 (49th ed.

2009), *available at* http://www.ici.org/pdf/2009_fact book.pdf.

In 1970, Congress attempted to address the problem of excessive fees by fortifying the provisions of the ICA. It imposed a fiduciary duty on mutual fund investment advisers with respect to their compensation. 15 U.S.C. § 80a-35(b). It also created a private right of action so that investors could enforce that duty in federal court. *Id.* Unfortunately, this ostensibly powerful remedy has been ineffective because the federal courts have consistently failed to interpret and apply the fiduciary standard in Section 36(b) with the breadth and rigor that it deserves. In fact, in the years since the adoption of Section 36(b), "no plaintiff has ever won a fee case brought under" its provisions. John P. Freeman, Stewart L. Brown & Steve Pomerantz, *Mutual Fund Advisory Fees: New Evidence and a Fair Fiduciary Duty Test*, 61 OKLA. L. REV. 83, 86 (2008).

The court below has compounded the problem by essentially writing Section 36(b) out of the ICA. The court held that the fiduciary duty is nothing more than a disclosure obligation, that courts should refrain from passing judgment on mutual fund advisory fees, and that the more modest fees that advisers charge other clients are irrelevant to the application of Section 36(b). All of these holdings conflict with the plain language of the ICA, the weight of authority interpreting Section 36(b), and Congress's obvious desire to deter abusive fee arrangements.

This Court should reverse the decision below and afford the Petitioners the opportunity to prove their claims at a trial on the merits. Further, the Court

should enunciate a strong and clear interpretation of Section 36(b), under which fee arrangements must be (1) untainted by deception in the negotiation process and (2) demonstrably fair and reasonable in light of all the facts and circumstances, including the more favorable fee structures that non-captive institutional clients are able to negotiate. Absent such a decision by this Court, millions of everyday investors across the country will continue to see their savings and retirement funds siphoned away as unjust enrichment for mutual fund advisers.

SUMMARY OF THE ARGUMENT

Section 36(b) of the ICA declares that investment advisers "shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services . . . ." 15 U.S.C. § 80a-35(b). The Petitioners allege that the Respondent has violated its fiduciary duty under Section 36(b) by exacting excessive fees from its captive mutual funds. The record before the court below included uncontroverted evidence that the Respondent charges its mutual funds more than twice what it charges the clients that it does not control. *Jones v. Harris Assocs.*, 537 F.3d 728, 731 (7th Cir. 2008) (Posner, J., dissenting from denial of petition for rehearing en banc). Nevertheless, the lower court affirmed the trial court's grant of summary judgment in the Respondent's favor. *Jones v. Harris Assocs.*, 527 F.3d 627, 635 (7th Cir. 2008).

The decision of the lower court was erroneous on three grounds. First, the court held that the fiduciary duty set forth in Section 36(b) only requires disclosure by the investment adviser during fee negotiations and imposes no substantive limitations on the magnitude

of the fees that the adviser may charge its mutual funds. *Id.* at 632. This is a profound departure from the proper legal standard that defines the fiduciary duty. The language of Section 36(b) and the cases applying the fiduciary duty make clear that Section 36(b) imposes two distinct requirements on investment advisers: not only must they be scrupulously honest in their dealings with respect to compensation, but the amount of their compensation must be fair and reasonable in light of all the facts and circumstances.

Second, the lower court held that some of the most compelling evidence of an excessive fee arrangement was irrelevant to the application of Section 36(b) and was therefore insufficient to raise a genuine issue of material fact warranting trial. *Id.* at 634-35. The court brushed aside the fact that the Respondent charges significantly lower fees to its independent institutional clients. Without citing any legal, economic, or empirical support, the court asserted that free market forces would inhibit any abuses that these price differentials might reflect. *Id.* The court furthermore speculated, again without support, that such fee disparities might be justified by differences in the amount of work an investment adviser performs for different clients. *Id.* at 634. Because these are precisely the genuine issues of material fact that require resolution at trial, the court erred by affirming dismissal based on the Respondent's motion for summary judgment.

Finally, the lower court's decision conflicts with the Congressional objectives underlying Section 36(b). The decisions of this Court, the legislative history of Section 36(b), and expert commentators all make abundantly clear that investment advisers have been

exploiting their captive mutual funds for decades. Intent on solving this problem, Congress adopted a series of increasingly powerful legislative remedies, culminating in Section 36(b) and the imposition of a fiduciary duty upon investment advisers with respect to their compensation. So far, however, the interpretation and application of Section 36(b) in the courts has been weak, affording little or no relief to aggrieved mutual fund shareholders. The lower court's ruling virtually guarantees that this trend will continue by eliminating any realistic prospect for success by investors with claims under Section 36(b). It therefore frustrates rather than advances Congress's goals, to the detriment of millions of investors, and it should be reversed.

ARGUMENT

I. THE FIDUCIARY DUTY IN SECTION 36(B) PROHIBITS MORE THAN DECEIT IN FEE NEGOTIATIONS; IT ALSO REQUIRES COURTS TO ENSURE THAT FEES ARE FAIR AND REASONABLE.

In defining the scope of the fiduciary duty under Section 36(b), the lower court focused exclusively on whether the adviser had made "full disclosure," played "tricks," or "pulled the wool over the eyes of the disinterested trustees . . . ." *Jones*, 527 F.3d at 632, 635. This exceedingly narrow interpretation of the fiduciary duty conflicts with the express wording of Section 36(b), innumerable cases defining the fiduciary duty, and the Congressional purposes set forth in the legislative history. Those authorities show that Congress intended courts to examine fee arrangements not only for fraud, but for substantive fairness as well.

A. The Plain Language Of Section 36(b) Shows That Congress Intended To Proscribe More Than Deceit.

The short answer to the lower court's attempt to equate breach of fiduciary duty with deceit lies in Section 36(b)(1) of the ICA. 15 U.S.C. § 80a-35(b)(1). It states that, in actions to enforce the fiduciary duty, "[i]t shall *not* be necessary to allege or prove that any defendant engaged in personal misconduct . . . ." *Id.* at § 80a-35(b)(1) (emphasis added). Thus, in Section 36(b), Congress plainly intended to address more than misconduct. It imposed the fiduciary duty not only to police fraud, but also to ensure that courts could engage in a meaningful review of the fairness of an adviser's fees.

The legislative history supports this reading of Section 36(b). The Senate Report frames the purpose of the bill not in terms of eradicating fraud, but rather in terms of addressing the conflicts of interest arising from an adviser's de facto control over the mutual funds that pay its fees. The Report explains that a mutual fund is typically organized and managed by its investment adviser, and therefore cannot, "as a practical matter[,] sever its relationship with the adviser." S. REP. NO. 91-184 (1969), *reprinted in* 1970 U.S.C.C.A.N. 4897, 4901, 1969 WL 4981. As a result, "the forces of arm's-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy." *Id.* The Report goes on to observe that the safeguards contained in the 1940 Act were inadequate because they "did not provide any mechanism by which the *fairness* of management contracts could be tested in court." *Id.* (emphasis added). Conspicuously absent

from the Report is any reference to Congressional concerns over advisers defrauding or similarly abusing their mutual funds. The Report thus refutes the lower court's notion that deceit defines the scope of the fiduciary duty in Section 36(b).[2]

B. The Fiduciary Duty Not Only Permits, But Affirmatively Requires, Courts To Scrutinize Fee Arrangements For Fundamental Fairness In Addition To Honesty In Negotiations.

In addition to ignoring the impact of Section 36(b)(1), the lower court failed to recognize the broad scope of the fiduciary duty. When Congress decided to adopt a fiduciary standard in Section 36(b), the concept had a well-established meaning, developed over decades under state and federal law in areas ranging from trusts and corporations to securities. The standard had evolved well beyond mere candor in negotiations, encompassing a duty of extreme care, loyalty, and fair dealing. As Chief Judge Cardozo explained in describing the fiduciary duty:

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[2] Section 36(b)(2), read in conjunction with Section 36(b)(1), further supports the inference that Congress intended courts to examine fees for fairness, not just corruption. Section 36(b)(2) provides that "approval by the board of directors of such investment company of such compensation . . . shall be given such consideration by the court as is deemed appropriate under all the circumstances." 15 U.S.C. § 80a-35(b)(2). If neither adviser misconduct nor mutual fund approval are dispositive in a case brought under Section 36(b), then the only conceivable purpose of the action must be an assessment of the fee itself—whether it is fair and reasonable.

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate.

Meinhard v. Salmon, 249 N.Y. 458, 464 (N.Y. 1928).

This Court's own pronouncements on the fiduciary duty have been similarly expansive. For example, in *Pepper v. Litton*, 308 U.S. 295 (1939), the Court set aside an attempt by a controlling shareholder to gain advantage over creditors in a bankruptcy proceeding. The Court observed that the dealings of fiduciaries must be subjected to "rigorous scrutiny" to ensure their "*inherent fairness* from the viewpoint of the corporation and those interested therein." *Id.* at 306 (emphasis added). The Court further admonished that a fiduciary "cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements." *Id.* at 311. In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the Court removed any doubt that investment advisers in general are fiduciaries, obligated not only to disclose all possible conflicts of interest to their advisory clients, but also to observe the "affirmative

duty of utmost good faith." *Id.* at 194 (footnote omitted).[3]

Against this backdrop, Congress's decision to incorporate a fiduciary duty into Section 36(b) speaks volumes. It reflects a resolve to hold investment advisers to the highest possible standard with respect to their compensation arrangements with the mutual funds they advise and manage. This is something vastly more substantive than a mere prohibition on dishonest bargaining tactics.[4]

Decisions following the enactment of Section 36(b) in 1970 reinforce this view. This Court, for example, recognized that Congress's primary goal in Section 36(b) was to ensure that mutual fund adviser fees were actually "reasonable" in amount, not simply to eradicate fraud or deception by investment advisers.

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[3] The legislative history indicates that Congress regarded the fiduciary duty in Section 36(b) as no less extensive than the fiduciary duty generally applicable to investment advisers: "Your committee believes that the investment adviser should be a fiduciary of the fund in such matters as the handling of the fund's assets and investments. Therefore, we have added a new section 36(b) to the investment company act to specify that the adviser has a fiduciary duty with respect to compensation for services or other payments paid by the fund or its shareholders to the adviser or to affiliated persons of the adviser." S. REP. NO. 91-184 at 4902.

[4] Congress imposed procedural limitations on actions to enforce the fiduciary duty under Section 36(b), but it did not weaken the duty itself. *But see Green v. Fund Asset Mgmt.*, 286 F.3d 682, 685 (3d Cir. 2002) (section 36(b) fiduciary duty is "more circumscribed than common law fiduciary duty . . ."). Presumably opponents of the fiduciary duty standard recognized the power and scope of the obligation it would impose and sought to limit its effect through the attendant procedural constraints.

Daily Income Fund, Inc. v. Fox, 464 U.S. 523 (1984). In *Daily Income Fund*, the Court exhaustively reviewed the history and rationale of Section 36(b), ultimately holding that Congress intended shareholders and the SEC—rather than mutual funds themselves—to enforce the fiduciary duty. *Id.* at 540-41. The opinion is replete with statements to the effect that the goal of the provision was to ensure "reasonable" adviser fees. *See, e.g., id.* at 534 n.10 (Congress believed "corporate waste actions were inadequate to ensure reasonable adviser fees"); *id.* at 537 (the SEC felt that percentage based compensation "could produce unreasonable fees in light of economies of scale"); *id.* at 540 (the SEC proposed the amendment due to concerns that structural governance requirements "would not alone ensure reasonable adviser fees"); *id.* at 540 ("Congress decided not to rely solely on the fund's directors to assure reasonable adviser fees . . . ."); *id.* at 541 ("Congress intended [court actions], on the one hand, and directorial approval of adviser contracts, on the other, to act as independent checks on excessive fees.").

An early decision from the Second Circuit offers an especially clear statement of the distinction under Section 36(b) between disclosure and fairness. In *Galfand v. Chestnutt Corp.*, 545 F.2d 807 (2d Cir. 1976), the court held that an adviser had breached his fiduciary duty under Section 36(b) by misleading the mutual fund's board in order to obtain "a patently one-sided revision of the advisory contract." *Id.* at 809. Although the decision focused on deceit as the basis for a Section 36(b) claim, the court nevertheless offered a comprehensive description of the dual obligations that all fiduciaries owe and that courts must enforce:

> Congress, in imposing a fiduciary obligation on investment advisers, plainly intended that their conduct be governed by the traditional rule of undivided loyalty implicit in the fiduciary bond. It is axiomatic, therefore, that a self-dealing fiduciary owes a duty of full disclosure to the beneficiary of his trust. . . . *Moreover, even where a fiduciary has made full disclosure, it is the duty of a federal court to subject the transaction to rigorous scrutiny for fairness.*

Id. at 811-12 (citing *Pepper*, 308 U.S. at 306-07) (emphasis added) (footnote omitted).

Cases decided since *Galfand* adhere to the view that Section 36(b) requires courts to scrutinize the amount that advisers charge their funds. Although many of those decisions are disappointing in the benchmark they set for what is "reasonable" or in the specific factors they consider, none of them has adopted the extraordinary hands-off approach that the lower court adopted in this case.

For example, in the leading decision applying Section 36(b), *Gartenberg v. Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923 (2d Cir. 1982), the Second Circuit held that courts must indeed assess the magnitude of an adviser's fee and weigh a host of factors to determine whether the fee is so large that it violates Section 36(b). *Id.* at 928-29. Among those factors were the adviser's costs, the quality of the services rendered, any economies of scale that the adviser enjoys, the volume of orders the adviser must process, and the expertise and care of the mutual fund board. *Id.* at 930. The court in *Gartenberg* left much to be desired in its formulation of what constitutes an

intolerably large fee, essentially acquiescing in any fee except one deemed "so disproportionately large that it bears no reasonable relationship to the services rendered . . . ." *Id.* at 928. In addition, as discussed below in Part II.B., the court took a narrow view of the evidence that courts should weigh in identifying unfair advisory fees. *Id.* at 930 n.3. Nevertheless, the *Gartenberg* decision at least pointed other courts in the right direction with respect to the nature of the inquiry they must undertake: a substantive evaluation of the fees in question, under all (or at least many) of the facts and circumstances.[5]

A recent decision from the Eighth Circuit offers a modern day articulation of the scope of the fiduciary duty under Section 36(b). In *Gallus v. Ameriprise Fin., Inc.*, 561 F.3d 816 (8th Cir. 2009), the court explicitly identified the two components of the adviser's duty: "[w]e believe that the proper approach to § 36(b) is one that looks to both the adviser's conduct during negotiation and the end result. . . . Unscrupulous behavior with respect to either can constitute a breach of the fiduciary duty." *Id.* at 823. The court held that the trial court should have more fully explored both aspects of the adviser's fee—whether the adviser secured it through deliberate omissions or obfuscations, *and* whether it was high in light of the fees charged to other institutional accounts. *Id.* at

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[5] The court in *Gartenberg* also explained that substitution of the term "fiduciary duty" for "reasonable" in the legislative process was "a semantical [rather] than substantive compromise." 694 F.2d at 928. And as noted above, in *Daily Income Fund*, this Court repeatedly described the 1970 amendment essentially as an attempt to ensure that mutual fund advisory fees were "reasonable." 464 U.S. at 534-41.

824. It reversed the trial court's grant of summary judgment and remanded for further proceedings.

The court below committed error by rejecting this line of decisions. It expressly disapproved the *Gartenberg* approach, offering instead its simplistic view that under Section 36(b), courts should content themselves with looking for trickery, not fair and reasonable fees. "[W]e now disapprove the *Gartenberg* approach. . . . A fiduciary must make full disclosure and play no tricks but is not subject to a cap on compensation." *Jones*, 527 F.3d at 632. The Seventh Circuit stands alone in suggesting that the fiduciary duty under Section 36(b) proscribes only concealment and that courts should refrain from determining whether fees are substantively fair or reasonable. Its holding nullifies the ability of mutual fund shareholders to challenge excessive investment adviser fees in court, in direct conflict with the provisions of Section 36(b) and Congress's intent. For this reason, it should be reversed.[6]

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[6] The lower court mischaracterized the scope of the fiduciary duty under state law as well. Trustee fees are in fact subject to judicial scrutiny for reasonableness. *See Restatement (Third) of Trusts* § 38 cmt. e (2001). In addition, cases under state law reflect a rigorous application of the fiduciary duty, specifically where corporate officers face unavoidable conflicts of interest. *See Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) (holding that merger was tainted due to lack of candor by directors serving parent and subsidiary and due to unfair share pricing; "[t]he requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts.").

II. UNDER SECTION 36(B), COURTS CAN AND SHOULD EXAMINE ALL THE FACTS BEARING ON THE FAIRNESS OF AN ADVISER'S COMPENSATION, INCLUDING FEES THAT THE ADVISER CHARGES TO NON-CAPTIVE CLIENTS.

The lower court erred by entirely discounting evidence in the record showing that the Respondent charges a significantly lower percentage of assets to the institutional clients that it does not manage or control. *Jones*, 527 F.3d at 634-35. This restrictive and counter-intuitive approach conflicts with the language and history of Section 36(b), the better reasoned case law, and scholarly opinion. At a minimum, such evidence creates genuine issues of material fact for trial. Unless courts are permitted to entertain the much lower fees that advisers charge their non-captive clients, plaintiffs will find it exceedingly difficult to advance to the trial stage, even with legitimate claims under Section 36(b). Unless this Court establishes the relevance of such evidence, Section 36(b) will never achieve its underlying purpose.

A. Congress Intended Courts To Entertain All Relevant Factors When Applying Section 36(b).

The structure of Section 36(b) and its legislative history show that Congress intended courts to consider a broad range of factors in cases challenging the reasonableness of an investment adviser's fee. As discussed in Part I.B. above, the fiduciary duty is an exacting standard of behavior, one that requires courts to examine all facets of a transaction to ensure

fairness. An adviser's practice of charging its captive mutual funds much higher fees than it charges its non-captive clients, without a factual justification, epitomizes the self-serving behavior that Congress intended to eliminate. Comparing those fee structures is obviously relevant as a court determines whether a breach of fiduciary has occurred.

The text of Section 36(b) certainly does not limit the type of evidence that a court may consider when evaluating a claimed breach of fiduciary duty. On the contrary, the language of Section 36(b) is fundamentally open-ended. It makes explicitly clear that misconduct by an adviser on the one hand, and board approval of fees by a mutual fund on the other, are factors that courts may consider, but they do not set the boundaries for a court's factual inquiry. *See* 15 U.S.C. § 80a-35(b)(1), (2).

The legislative history confirms that courts are expected to engage in a comprehensive factual inquiry under Section 36(b). The Senate Report states that "[i]n the event that court action is brought to enforce this fiduciary duty of an investment adviser as to compensation or payments received by him, it is intended that the court look at *all the facts* in connection with the determination and receipt of such compensation . . . ." S. REP. NO. 91-184 at 4910 (emphasis added). The report indicates that a principal focus should be on services rendered to the fund and compensation paid for those services. *Id.* Many courts have emphasized those considerations. *See Krantz v. Prudential Invs. Funds Mgmt.*, 305 F.3d 140, 143 (3d Cir. 2002) (court must examine the relationship between the fees charged and the services rendered); *Migdal v. Rowe Price-Fleming Int'l, Inc.*,

248 F.3d 321, 327 (4th Cir. 2001) (same). However, the Senate Report also states that under certain circumstances, a wider, comparative analysis may be appropriate, one that looks beyond the relationship between the adviser and the mutual fund immediately at issue. S. REP. NO. 91-184 at 4910. The specific examples cited in the report concern the fees that an adviser charges to other funds in a mutual fund complex, but the report does not suggest that those examples should be considered exhaustive.

Nor would it make any sense from the standpoint of legislative history and statutory construction to read such an evidentiary limitation into Section 36(b). The most harmful and persistent trend that gave rise to Section 36(b) was that "investment advisers often charged mutual funds higher fees than those charged the adviser's *other* clients." *See Daily Income Fund*, 464 U.S. at 537 (citing the Wharton School Study of Mutual Funds that prompted the SEC to propose the 1970 amendments) (emphasis added). It is untenable to suggest that when applying Section 36(b), courts must ignore the very type of evidence that helped inspire the legislation in the first place. Yet such evidence is precisely what the lower court refused to consider in this case.

B. Recent Case Law Appropriately Acknowledges That The Fees Advisers Charge To Non-Captive Clients Are Relevant Under Section 36(b) And May Create Genuine Issues Of Material Fact.

Early case law construing Section 36(b) summarily discounted evidence reflecting the markedly lower prices that advisers have historically charged to

unaffiliated clients. In *Gartenberg*, for example, the Second Circuit simply asserted that such evidence must be rejected because "the nature and extent of the services required by each fund differ sharply." 694 F.2d at 930 n.3. The court offered no support for this contention, legal or factual.

Fortunately, not all courts have adhered to this view. In *Gallus*, the Eighth Circuit expressly rejected this aspect of the holding in *Gartenberg*. It ruled that the trial court had "erred in rejecting a comparison between the fees charged to Ameriprise's institutional clients and its mutual fund clients." 561 F.3d at 823. It explained that the fee comparison was especially *appropriate* because, under the facts of the case, "the investment advice may have been the same for both accounts," making different fee structures all the more suspect. *Id.* at 824.

The court in *Gallus* also correctly rejected the "free market" rationale for excluding evidence of an adviser's differential pricing for its clients. The court was "unpersuaded" that such fee disparities must be accepted simply as a reflection of what the market will bear. *Id.* The court explained that "[t]he purpose of an inquiry into the fees paid by institutional, non-fiduciary clients is to determine what the investment advice is worth." *Id.* That valuation is directly relevant to a claim under Section 36(b), because if an investment adviser charges more than what its services are worth, it is abusing its relationship and breaching its fiduciary duty. Commentators agree: "the *Gartenberg* court's greatest failing was its refusal to accept that the pricing of investment advisory services offered in the free market provides a legitimate and helpful guidepost for evaluating such

services in the fund market." Freeman, 61 OKLA. L. REV. at 86; *see also Jones*, 537 F.3d at 732 (Posner, J., dissenting) (lamenting that the panel's approach will allow "exorbitant fees" to become the "industry's floor").[7]

In *Gallus*, the court acknowledged that advisers will challenge such evidence on grounds that "the comparison with institutional clients is inapt or that the discrepancy is substantively justified." 561 F.3d at 824. But as the court noted, such contentions simply create "disputed issues of material fact." *Id.* at 824. This highlights the procedural infirmity in the lower court's ruling. The point here is not that fee disparities are conclusive proof of a breach of fiduciary duty, only that they might be. Their significance depends on all the facts and circumstances, including any explanations that an adviser might offer. Such factual determinations are appropriate for resolution at trial, not on motions to dismiss or for summary judgment. Those fee disparities should not be excluded from consideration as a matter of law, and the lower court erred in so holding.

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[7] The SEC's regulations confirm the relevance of the fees that advisers charge their non-mutual fund clients. In 2004, the SEC adopted regulations requiring mutual funds to disclose the factors they considered when they selected an adviser and approved its fees. Those factors include whether the board compared the approved contract with other contracts, such as contracts between the investment adviser and "other types of clients (e.g. pension funds and other institutional investors)." 17 C.F.R. § 240.14a-101(c)(11)(i).

III. THE LOWER COURT'S INTERPRETATION OF SECTION 36(B) EVISCERATES CONGRESS'S CAREFULLY CHOSEN REMEDY AND THWARTS ATTAINMENT OF A VITALLY IMPORTANT CONGRESSIONAL OBJECTIVE.

The lower court's interpretation of Section 36(b) eliminates any hope that this legislative remedy will achieve Congress's goal of eradicating excessive investment adviser fees in the mutual fund industry. This is especially discouraging not only because those fees harm so many millions of investors, but because the problem has persisted for so long. Reversal is important in this case to revitalize Section 36(b) as means of protecting investors from abuse and to restore confidence in the integrity of the mutual fund market.

The conflicts of interest that gave rise to predatory fee arrangements have been recognized since the 1930s, and they helped inspire passage of the ICA in 1940. *Daily Income Fund*, 464 U.S. at 536. Congress's initial remedy was to impose corporate governance controls, including independent director requirements. *Burks v. Lasker*, 441 U.S. 471, 482 (1979). Studies thereafter indicated, however, that investment advisers continued to charge mutual funds high fees relative to other clients, and that the "structure of the industry, even as regulated by the Act, had proven to be resistant to efforts to moderate adviser compensation." *Daily Income Fund*, 464 U.S. at 537 (citing Wharton School Study of Mutual Funds and SEC studies). Part of the problem was that investors had no meaningful judicial recourse because the applicable corporate waste standards applicable under

state law were insuperably high. S. REP. NO. 91-184 at 4901; *Daily Income Fund,* 464 U.S. at 541 n.12. Section 36(b), with its fiduciary duty enforceable in federal court, was thus born from an unusually long and frustrating effort to rectify a systemic problem in the mutual fund industry.

The abuses have largely persisted notwithstanding enactment of Section 36(b). "Fee gouging remains pervasive within the fund industry." Freeman, 61 OKLA. L. REV. at 149. The promise of Section 36(b) may yet be fulfilled if it is forcefully interpreted and applied by the courts. The lower court's ruling, however, removes any chance that Section 36(b) can achieve Congress's objectives. By equating fiduciary duty with garden variety fraud, the lower court has nullified the powerful standard that Congress intended to deploy and has stripped Section 36(b) of any real force or effect. And by disallowing evidence of prices charged to non-captive clients, the lower court has robbed plaintiffs of the most meaningful benchmark for determining whether fees are reasonable. "Relegating plaintiff shareholders to comparing a given fund's no-bid pricing schedules to other similar funds' no-bid pricing schedules will never yield any fee relief for shareholders . . . ." Freeman, 61 OKLA. L. REV. at 142. In effect, the lower court's decision repeals Section 36(b) and should be reversed.

CONCLUSION

For the reasons set forth above, the decision of the United States Court of Appeals for the Seventh Circuit should be reversed.

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June 17, 2009

AMICUS CURIAE BRIEF

No. 08-586

IN THE

Supreme Court of the United States

JERRY N. JONES, MARY F. JONES, AND ARLENE WINERMAN,

Petitioners,

v.

HARRIS ASSOCIATES, L.P.,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION AS *AMICUS CURIAE* IN SUPPORT OF RESPONDENT

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August 27, 2009

WILSON-EPES PRINTING CO., INC – (202) 789-0096 – WASHINGTON, D.C. 20002

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INTEREST OF *AMICUS CURIAE*

The Securities Industry and Financial Markets Association ("SIFMA") brings together the shared interests of more than 600 securities firms, banks, and asset managers locally and globally through offices in New York, Washington, D.C., and London. Its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong. SIFMA's mission is to champion policies and practices that benefit investors and issuers, expand and perfect global capital markets, and foster the development of new products and services. More information about SIFMA is available at http://www.sifma.org.

SIFMA has a particular interest in this litigation because of its potential adverse impact on the securities industry. Petitioners seek a construction of the Investment Company Act that would make every case fact-dependent and subject to unwarranted, yet detailed judicial scrutiny. Were the Court to adopt Petitioners' approach, a motion to dismiss would be virtually futile even in the most meritless cases, and litigation costs would increase across the industry. As this Court has recognized, such costs can have significant "ripple effects" that are detrimental to issuers and investors alike. *Cent. Bank of Denver* v. *First Interstate Bank of Denver*, 511 U.S. 164, 189 (1994); see also *Stoneridge Invest. Partners, LLC* v. *Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 772 (2008) (explaining how prospect of "extensive discovery" can enable "plaintiffs with weak claims to extort settlements from innocent companies"). Accordingly,

SIFMA respectfully urges this Court to affirm the decision below.[1]

SUMMARY OF ARGUMENT

1. This case presents what should be a straightforward application of Section 36(b) of the Investment Company Act of 1940, 15 U.S.C. § 80a-35(b) ("ICA"). Petitioners are shareholders in a mutual fund. They purchased their shares in arm's-length transactions after the fee rates – which were ordinary for the industry – were fully disclosed to them. Since then, the fee rates were never increased, and Petitioners never had to pay a single penny more than what they agreed to pay at the outset. In no ordinary sense of the word were Petitioners treated unfairly, let alone unlawfully.

Nonetheless, Petitioners contend that the mutual-fund adviser breached a fiduciary duty by maintaining the terms of the original deal, instead of voluntarily decreasing the rates. Petitioners claim that this result is compelled by the common law of trusts. For two reasons, however, Petitioners are mistaken.

First, by its terms, Section 36(b) does not incorporate the law of trusts. The provision makes no mention of trust law; it expressly rejects the trust law rule of imposing the burden of proof on the fiduciary; and it contemplates an active role for independent directors and judicial deference to those directors, a

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief are on file or have been submitted to the Clerk. Pursuant to this Court's Rule 37.6, *amicus* states that this brief was not authored in whole or in part by counsel for any party, and that no person or entity other than *amicus* or its counsel made a monetary contribution intended to fund the preparation or submission of this brief.

construct that is unknown to the common law of trusts. Moreover, Congress was well aware of what it was doing when it enacted the statute. As the legislative history reflects, Congress determined that "the unique structure of mutual funds" made it difficult to apply "traditional fiduciary standards." Congress instead contemplated "federally-created fiduciary dut[ies]" designed with an eye toward "best industry practice" and "business judgment." S. Rep. No. 91-184 (1969), *available at* 1970 U.S.C.C.A.N. 4897, 4898, 4902-03 (1969) ("Senate Report").

Second, even if trust law did apply, it would not support Petitioners' position. Trust law requires "fairness," Pet'r Br. 22, and there is nothing unfair in simply following the terms of an agreement properly struck, fully disclosed, and voluntarily accepted by the shareholders. Under the common law, "a provision in the [trust] instrument is given effect absent extraordinary or special circumstances." *Baltrotsky* v. *Kugler*, 910 A.2d 1089, 1098-99 (Md. 2006). It is thus no surprise that Petitioners and their *amici* fail to cite a single common law trust case suggesting that a fee is unlawful when it is the product of an arm's-length transaction, voluntarily entered into after disclosure of the rate.

2. In any event, even in cases in which the adviser's fee rate increases (which did not occur here), and the shareholder has to pay more than what he initially bargained for, Section 36(b) does not permit judicial rate regulation of the kind advocated by Petitioners. Instead, the statute contemplates a significant role for investment company directors and judicial deference to those directors in light of all the relevant circumstances. Among those circumstances is the state of the marketplace, as the Solicitor General argued. Br. of United States 25-29. Because the

mutual fund market is highly competitive, and the competition provides an extrinsic check on excessive fees, courts should apply a presumption that the fiduciary did not breach its duties by charging an excessive fee. Even in the absence of competition, however, courts should not intrusively second-guess the adviser's fees, but instead adopt an approach that gives full "consideration" to the board of directors' independence, conscientiousness, and compliance with statutory procedures. See ICA § 36(b)(2).

FACTUAL BACKGROUND

1. Over the past four decades, the mutual fund industry has experienced substantial growth that, in tandem with increased competitiveness and technological development, empowers millions of investors to make educated investment decisions. More than ever before, investors have the ability to research the thousands of existing mutual funds, often at little or no cost to the investor, and to find the funds that offer the lowest fees and that otherwise meet the investors' selected criteria. Not coincidentally, over the same time period, total fees have declined across the industry, as investors are able to vote with their feet, both when they enter the market and when they make changes to their portfolios.

a. The industry is far larger today than it was in the 1960s. In the early '60s, fewer than 200 funds existed. And, as late as 1966, only 379 funds managed a total of just over $38 billion. See John Coates & R. Glenn Hubbard, *Competition in the Mutual Fund Industry: Evidence and Implications for Policy*, 33 J. Corp. L. 151, 156-57 (2007).

The number of funds increased substantially over the next forty years: in 2008, there were nearly 9,000 funds in the United States alone. Inv. Co. Inst.

("ICI"), *2009 Investment Company Factbook* 15 (2009) ("*Investment Company Factbook*"), *at* http://www.ici.org/pdf/2009_factbook.pdf. The rapid growth reflects the industry's relatively low barriers to entry, see *id.* at 12-14 & figs.1.5-.8; Coates & Hubbard, *supra*, at 167-70, and the increase in the amount of money invested in mutual funds. By 2008, mutual funds managed almost $10 trillion in investment capital. *Investment Company Factbook*, *supra*, at 9 fig.1.1. Nearly 20 percent of all household financial assets are now held in investment companies. *Id.* at 10 fig.1.2.

b. As competition has expanded, fees and expenses have dropped. Between 1980 and 2008, the asset-weighted average of total fees and expenses (which includes sales loads plus management, 12b-1, and other fees and expenses) fell among bond and stock funds by more than 57 and 63 percent, respectively.[2] ICI, *Trends in the Fees and Expenses of Mutual Funds, 2008*, at 2 fig.1 (2009), *at* http://www.ici.org/pdf/fm-v18n3.pdf. Indeed, the Securities and Exchange Commission ("SEC") has recognized that, accounting for sales loads, the fees and expenses paid by investors have probably declined. *Report on Mutual Fund Fees and Expenses* (Dec. 2000), *at* http://www.sec.gov/news/studies/feestudy.htm.

This decrease is not surprising. Today, thousands of funds compete for investors, and the size of fees is one important basis for distinguishing among the funds. Petitioners' arguments notwithstanding, see Pet'r Br. 42-44, investors today are highly concerned

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[2] It is important to point out that, for regulatory reasons, "expense ratios" do not necessarily describe investors' total costs of ownership. In particular, mutual fund "expense ratios" do not take into account sales loads.

about fees. In fact, a recent survey commissioned by ICI revealed that consumers are more likely to review fees and expenses than any other type of information before purchasing shares in a mutual fund, and most investors continue to monitor fees and expenses after making their purchase. ICI, *Understanding Investor Preferences for Mutual Fund Information* 3 fig.1 (2006), *at* http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf.

Not only are investors interested in fees and expenses, but they have the technology to sort through thousands of mutual funds according to fees, expenses, and other criteria that they deem most relevant to their investment decisions, such as the risk profile of a particular fund's investment strategies. The SEC and the Financial Industry Regulatory Authority ("FINRA") both provide free online calculators to help prospective investors determine how much investing in a given fund will cost over time. SEC, The SEC Mutual Fund Cost Calculator, http://www.sec.gov/investor/tools/mfcc/mfcc-intsec.htm (last visited Aug. 26, 2009); FINRA, Fund Analyzer, http://apps.finra.org/fundanalyzer/1/fa.aspx (last visited Aug. 26, 2009). Meanwhile, a wide variety of financial service agencies and media outlets, such as theStreet.com, Yahoo Finance, USA Today, and Morningstar, provide free or low-cost research and screening tools that allow prospective investors to determine for themselves which funds best meet their personal investment goals. To take one example, SmartMoney.com, a division of the Wall Street Journal's digital network, provides a free online "Mutual Fund Map" that accounts for the relative sizes and investment classification of thousands of funds, provides links to each, and allows a casual researcher to compare fundamentals such as performance, fees,

and turnover. See SmartMoney.com, Mutual Fund Map, http://www.smartmoney.com/fundmap (last visited Aug. 26, 2009). Brokerages may offer additional research and screening to their customers. As a result, investors now enjoy unprecedented ability to select among thousands of different mutual funds according to the investors' own criteria, making it more possible than ever for prospective shareholders to tailor their investments to their personal goals and preferences.

2. Consistent with the industry as a whole, the fee rates for Respondent's funds in question have declined over time. Each of the three funds – Oakmark Fund, Oakmark Equity and Income, and Oakmark Global Fund – has a separate fee schedule with breakpoints. *Jones* v. *Harris Assocs. L.P.*, 527 F.3d 627, 631 (7th Cir. 2008); *Jones* v. *Harris Assocs. L.P.*, No. 04-8305, 2007 WL 627640, at *2 (N.D. Ill. Feb. 7, 2007). The fee rate starts off at one percent or less, depending on the fund, and declines as the fund grows in size. In no instance did Respondent increase the advisory fee rates for any of these funds.

Moreover, Respondent added new breakpoints in 2003 and 2004, potentially lowering the effective rates. Def's Br. in Support of Summ. J. 5-6, No. 04-8305 (N.D. Ill. filed Sept. 12, 2006). Petitioners are thus challenging fee rates that are the same as or lower than the rates Petitioners agreed to pay when they voluntarily bought their shares in the funds. Petitioners selected these funds from among their mutual fund options in arm's-length transactions, and since then Petitioners have not had to pay anything more than what they agreed to pay after disclosure of the fee rates.

ARGUMENT

I. INVESTMENT ADVISERS DO NOT BREACH THEIR FIDUCIARY DUTIES WHEN THEY CHARGE NO MORE THAN THE FEES THAT WERE FULLY DISCLOSED TO SHAREHOLDERS, WHO VOLUNTARILY PURCHASED THEIR SHARES IN ARM'S-LENGTH TRANSACTIONS.

1. As an initial matter, it is important to stress what this case is not about. First, it is not about an increase in fees imposed on shareholders after they bought their shares. In fact, the advisory fee rates for these funds have never grown, and by imposing new breakpoints Respondent permitted a decrease in the fees that shareholders pay over the life of the funds. In no circumstance did any investor pay anything more than what the investor agreed to pay when the investor bought shares in the fund.

Second, this is not an action by the SEC to enforce the many obligations that the ICA imposes on directors and other participants in the mutual fund industry. See, *e.g.*, ICA § 15(c) (imposing duty on directors to request and scrutinize, and on advisers to disclose to directors, information necessary to evaluate the terms of the adviser's contract); *id.* § 36(a) (SEC may enforce fiduciary duty provisions against directors); *id.* § 34(b) (unlawful to make untrue statements in ICA filings); see also *N.Y Life Invest. Mgmt., LLC*, Release Nos. 2883 & 28747, slip op. at 10 (SEC May 27, 2009) (Order Instituting Administrative Cease-and-Desist Proceedings) (respecting, *inter alia*, ICA §§ 9(b), (f), 15(c), 34(b)). The only provision in the ICA that this case implicates is Section 36(b). The Court's decision will not affect the SEC's oversight or authority to initiate enforcement actions under other provisions of the statute or other securities laws.

Directors' and advisers' fiduciary duties under those provisions will remain unchanged.

2. This case thus presents a very narrow question: Do investment advisers breach a fiduciary duty by charging only the fee rates that the shareholders agreed to pay in arm's-length transactions after full disclosure of the rates? To ask the question is to answer it. Because there is nothing unfair in simply preserving the terms of an arm's-length agreement – especially considering the many investment options the shareholders had when they voluntarily chose to invest in Respondent's funds – Respondent did not breach any fiduciary duty under Section 36(b).

Contending otherwise, and seeking rigorous judicial rate regulation, Petitioners purport to invoke the common law of trusts. But their reliance is misplaced for two independent reasons. First, Congress did not import trust law into Section 36(b). Second, even under the common law of trusts, there is nothing unlawful in maintaining the original terms of an arm's-length agreement.

a. Contrary to Petitioners' suggestion, nothing in Section 36(b) incorporates or even references the law of trusts. Petitioners point to the phrase, "fiduciary duty," and note that, when Congress uses a term with a "familiar" and "settled meaning under ... the common law," Congress intends to adopt that established meaning. Pet'r Br. 20 (internal quotation marks omitted) (quoting *Neder* v. *United States*, 527 U.S. 1, 21 (1999)). The phrase "fiduciary duty," however, does not have (and did not have in 1970) a single, settled meaning linked to the law of trusts.

Rather, the term has appeared in diverse settings, reflecting its context-dependent nature. See *SEC* v. *Chenery Corp.*, 318 U.S. 80, 85-86 (1943) ("[T]o say

that a man is a fiduciary only begins analysis; it gives direction to further inquiry."); *Konover Dev. Corp.* v. *Zeller*, 635 A.2d 798, 806 (Conn. 1994) (fiduciaries can take the form of "agents, partners, lawyers, directors, trustees, executors, receivers, bailees, and guardians"), Tamar Frankel, *Fiduciary Law*, 71 Cal. L. Rev. 795, 795 (1983) (noting that "various types of fiduciaries have evolved over the centuries," including "[t]rustees ... of ancient origin" and corporate directors, majority shareholders, union leaders, and psychiatrists of much more recent vintage). When the ICA was amended in 1970, there was thus substantial contemporaneous confusion regarding the meaning of the term "fiduciary duty" in the statute. See, *e.g.*, William J. Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179, 191 (1971) ("The 1970 Amendments ... do not define the scope of this [fiduciary] obligation; nor does the legislative history indicate that the Commission and industry spokesmen ever agreed upon a common definition."); *id.* at 202 ("[T]he legislative history of the 1970 Amendments is silent on whether ... section 36(b)'s 'breach of fiduciary duty' standard[] merely recite[s] state law definitions or instead impl[ies] that federal courts should fashion a uniform federal standard."); Note, *Mutual Funds and Their Advisers: Strengthening Disclosure and Shareholder Control*, 83 Yale L.J. 1475, 1478-79 (1974) ("What constitutes a breach of fiduciary duty under this section is, however, enigmatic."); see also *Fogel* v. *Chestnutt*, 668 F.2d 100, 112 (2d Cir. 1981) (describing Section 36(b) as "a lesson in the art of studied ambiguity in drafting of statutes").

In some of the settings in which there is a fiduciary duty, the law of trusts is relevant, and in others, it is not. Compare, *e.g.*, *Cent. States, Se. & Sw. Areas*

Pension Fund v. *Cent. Transp., Inc.*, 472 U.S. 559 (1985) (describing ERISA's roots in the law of trusts), and *Chauffeurs Local 391* v. *Terry*, 494 U.S. 558 (1990) (analogizing union's duty of fair representation to trustee's fiduciary duty), with *Schein* v. *Chasen*, 478 F.2d 817 (2d Cir. 1973) (extending fiduciary duty to tippees of corporate executives for purposes of insider trading liability), *vacated on other grounds sub nom.* 416 U.S. 386 (1974), and *Shlensky* v. *Wrigley*, 237 N.E.2d 776 (Ill. App. Ct. 1968) (refusing to question idiosyncratic decision of corporate executive despite fiduciary duty owed to shareholders).[3]

Likewise, in some settings, courts engage in a substantive fairness review, whereas in others, courts do not. For instance, judges do not assess the substantive fairness of stock transactions between corporate officers and shareholders, despite an officer's fiduciary duty, but instead ask only if the officer disclosed all material information. See, *e.g.*, *Jernberg* v. *Mann*, 358 F.3d 131, 136 (1st Cir. 2004). Similarly, the fiduciary duties of partners "arguably should be less extensive than those in other agency or trust relationships." 2 *Bromberg & Ribstein on Partnership* § 6.07(a) (2009); see also Revised Uniform Partnership Act § 4.04(e)-(f) (2008) (partners allowed to act selfishly without breaching fiduciary duties). This is

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[3] Even when a particular fiduciary duty is explicitly linked to the common law of trusts, as in the ERISA context, the law of trusts is not absolutely dispositive of the scope of the duty. *See, e.g.*, *Varity Corp.* v. *Howe*, 516 U.S. 489, 496-97 (1996) (ERISA fiduciary duties "draw much of their content from the common law," but "partly reflect a congressional determination that the common law of trusts did not offer completely satisfactory protection"), *Mertens* v. *Hewitt Assocs.*, 508 U.S. 248, 251-52 (1993) (ERISA assigns fiduciaries duties not known at common law, such as plan administration, investment activities, record-keeping, and disclosure obligations).

due to "the greater availability ... of extrajudicial controls," which include aspects of the partnership relationship that resemble the mutual fund industry, including "the terminability of the relationship, and the alignment of incentives of the partners." 2 *Bromberg & Ribstein, supra*, § 6.07(a).

And, in perhaps the most familiar context, courts refrain from substantive review of corporate decisionmaking under the business judgment rule absent a showing of procedural irregularity or self-dealing. See, *e.g.*, *Shlensky*, 237 N.E.2d 776. Like the business judgment rule, the type of fiduciary duty that Congress envisioned in Section 36(b) arises out of a concern that courts not substitute the business judgment of corporate officers with the courts' own *post hoc* judgment. See Senate Report, *supra*, at 4902-03. In any event, these examples of limited substantive review illustrate the fundamental principal that "[s]imply classifying a party as a fiduciary inadequately characterizes the nature of the relationship." *Konover*, 635 A.2d at 806. When reviewing the actions of a fiduciary, such as an investment fund manager, courts account for context. See, *e.g.*, *Rexford Rand Corp.* v. *Ancel*, 58 F.3d 1215, 1219 n.7 (7th Cir. 1995) ("[A] court must examine the relationship between the parties in each case so as to ascertain the standard to be applied to determine whether there has been a breach of a partner's fiduciary duty.") (quoting *Saballus* v. *Timke*, 460 N.E.2d 755, 760 (Ill. App. Ct. 1983)); *Lawrence* v. *Cohn*, 197 F. Supp. 2d 16 (S.D.N.Y. 2002) (requiring general partner, serving as executor, to offer limited partners only a fractional partnership interest, based on circumstances and equities of relationship), *aff'd*, 325 F.3d 141 (2d Cir. 2003).

Petitioners offer no reason why the ICA should be read to have incorporated the strict rules governing trustees rather than the flexible standards governing other fiduciaries. The duties applied to trusts are of the highest magnitude, and for good reason. See, *e.g.*, Restatement (Second) of Trusts § 2 cmt. b (1959) ("The duties of a trustee are more intensive than the duties of some other fiduciaries."); *Meinhard* v. *Salmon*, 164 N.E. 545, 546 (N.Y. 1928) (Cardozo, C.J.) ("A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior."). In general, trustees are practically unencumbered by procedural limits on their discretion, while beneficiaries have little or no ability to influence the trustee's decisions or to remove their funds from the trustee's care. See, *e.g.*, Restatement (Second) of Trusts § 337 (termination of trust through consent of beneficiaries).

The responsibilities ascribed to other types of fiduciaries are more flexible and generally amendable by contract. See, *e.g.*, Restatement (Second) Agency § 376 (1958) (agent's duties determined by parties' agreement, absent fraud, duress, illegality, or incapacity); *id.* § 443 ("If the contract of employment provides for compensation to the agent, he is entitled to receive ... the definite amount agreed upon ...."); Revised Uniform Partnership Act § 401 cmt. 1 (noting default compensation rules are subject to revision by contract). In each case, important nonjudicial checks, such as low barriers to exit, limit strategic behavior without the need for scrutinous judicial review of contractual agreements. See, *e.g.*, 2 *Bromberg & Ribstein*, *supra*, § 6.07(a) ("Fiduciary duties in the partnership arguably should be less extensive than those in other agency or trust relationships because

of the greater availability in the partnership of extra-judicial controls, including ... the terminability of the relationship, and the alignment of incentives of the partners ....").

The mutual fund-shareholder relationship is much less similar to the captive relationship between trustee and beneficiary than to the relationship between an agent and principal, or among partners. Unlike trust beneficiaries, investment company shareholders are protected by a board of directors that cabins the discretion of investment company advisers. More importantly, shareholders can exercise a powerful check on advisers' behavior: they can typically redeem their shares and walk away from the adviser, generally without further expense other than taxes. If the funds are held within a tax-exempt account, investors need not even realize capital gains when they exit the fund. In addition, shareholders must approve any increase in fee rates by a majority vote. See ICA § 15(a). Of course, investors also exercise the ultimate discretion in electing not to invest in particular funds in the first instance. In short, unlike beneficiaries of a trust, mutual fund investors are not captive to the acts and decisions of their investment advisers. Nothing in the logic or policy of the ICA suggests the fiduciary duty applied to mutual fund managers should equate to that applied to trustees.

Moreover, it is readily apparent from the text of Section 36(b) that Congress did not intend to import the law of trusts into the statute. Congress knows how to incorporate trust law into legislation, and has done so in other statutes. See 29 U.S.C. § 1103(a) (establishing that all assets of employee benefit plans are to be "held in trust" and further establishing a "trustee" to manage the plans); *id.* § 1346 (requiring reports to "trustee" upon intended termination of a

plan); see also *Cent. States*, 472 U.S. at 570 ("[R]ather than explicitly enumerating all of the powers and duties of trustees and other [ERISA] fiduciaries, Congress invoked the common law of trusts to define the general scope of their authority and responsibility.") (emphasis omitted). It did not do so in Section 36(b), which never mentions the word "trust."

Indeed, the text of Section 36(b) is plainly at odds with the common law of trusts. For instance, Section 36(b) places the burden of proof on plaintiffs, reversing the common law's approach to fiduciary duties. See, *e.g.*, *Paramount Commc'ns, Inc.* v. *QVC Network, Inc.*, 637 A.2d 34, 44 (Del. 1994) (fiduciaries bear burden of proof to establish they acted reasonably); *Digiacobbe* v. *Sestak*, No. Civ. A. 14525, 2003 WL 1016985, at *5 (Del. Ch. Mar. 3, 2003) ("The burden of proof in an accounting is generally stated simply as resting upon the party who is required to account."); Conn. Civil Jury Instr. 3.8-2(B) (fiduciary defendant must prove by clear and convincing evidence that the challenged act "was the product of fair dealing, good faith, and full disclosure"). Congress shifted the burden in order to deter costly nuisance suits, like the one filed by Petitioners. See, *e.g.*, H.R. Rep. No. 91-1382, at 8 (1970) (increasing "burden of proof ... to prevent the harassment of investment advisers by ill-founded and nuisance law suits, the so-called strike suit").

In addition, the statute contemplates an active role for independent directors in negotiating and setting fee rates, and expects courts to defer to those business decisions under appropriate circumstances. See ICA §§ 15(c), 36(a), 36(b); see also *Burks* v. *Lasker*, 441 U.S. 471, 485 (1979) ("Congress entrusted to the independent directors ... the primary responsibility for looking after the interests of the fund's shareholder-

ers ...."). Assigning a role for a board of directors is unknown in the common law of trusts, which recognizes only the interaction of trustees, beneficiaries, and settlors. See, *e.g.*, Restatement (Second) of Trusts § 3 (defining parties relevant in trust law). Furthermore, the Restatement (Second) of Trusts specifically excludes "business trusts," a type of entity that includes investment companies such as Respondent, from the scope of its analysis of trust law. *Id.* § 1 cmt. b ("Although many of the rules applicable to trusts are applied to business trusts, yet many of the rules are not applied, and there are other rules which are applicable only to business trusts."). In light of Congress's failure even to use the word "trust" in Section 36(b), and the ICA's many significant conflicts with the common law of trusts, it is evident that Congress did not incorporate trust law into the ICA.

Finally, the statute's legislative history further undercuts any claim that Congress intended to apply trust law. The Senate Report on which Petitioners rely concluded that "the unique structure of mutual funds has made it difficult for the courts to apply traditional fiduciary duty standards in considering questions concerning management fees." Senate Report, *supra*, at 4898; *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 536 (1984) (describing § 36(b) as a "unique right"). So, instead of these traditional duties, the report contemplated "federally-created fiduciary dut[ies]." Senate Report, *supra*, at 4902-03. The scope of these federal duties, the Committee determined, should be determined with an eye toward "best industry practice" and "business judgment." *Id.* Petitioners' analogy to trust law fails.

b. At any rate, even if the Court were to apply the law of trusts – implicating the highest fiduciary standards – those duties would not require Respondent to

reduce the fees that were fully disclosed to the shareholders when they voluntarily bought their shares in arm's-length transactions. As Petitioners note, trust law requires "fairness," Pet'r Br. 22, and there is nothing unfair in simply following the terms of an agreement properly struck, fully disclosed, and voluntarily accepted.

Indeed, the common law of trusts follows a "well established rule" that is essentially the opposite of what Petitioners are advocating here. *Baltrotsky*, 910 A.2d at 1098-99. Under the common law, although "courts have the inherent power to review compensation paid to trustees from trust assets," courts give effect to the provisions in the trust instruments "absent extraordinary or special circumstances." *Id.* (quoting *Bunn* v. *Kuta*, 674 A.2d 26, 30-32 (Md. Ct. Spec. App. 1996)); see also *id.* at 1099 ("Our holding is harmonious with the overarching contract law principle that express contracts are enforced as written."). "It is well settled that where there is a valid agreement between settlor and trustee fixing the terms of the trustee's compensation, courts must ordinarily enforce the terms of the agreement without making an independent determination of whether the terms are reasonable." *In re Duncan Trust*, 391 A.2d 1051, 1055 (Pa. 1978); see also, *e.g.*, *In re Estate of Perlberg*, 694 S.W.2d 304, 306 (Tenn. Ct. App. 1984) ("In Tennessee and in virtually every other jurisdiction that has addressed the issue, where a will specifies that an executor is to receive a certain amount as compensation, or no compensation, for serving as an executor, he, by accepting the appointment, binds himself to the will's terms."); *Ladd* v. *Pigott*, 114 S.W. 984, 987 (Mo. 1908) (rule allowing courts to fix trustees' compensation "is inapplicable where the amount of the compensation to be paid has been fixed by

contract"); *Meacham* v. *Sternes & Sheldon*, 9 Paige Ch. 398 (Ch. 1842) ("Where the instrument creating the trust ... fixes a different compensation ... that of course must prevail.").

The Restatement (Second) of Trusts is in accord. See Restatement (Second) of Trusts § 242 cmt. f ("If by the terms of the trust it is provided that the trustee shall receive a certain amount of compensation for his services as trustee, he is ordinarily entitled to that amount ...."). Moreover, as the Restatement explains, after the trust is created, the compensation may be enlarged or diminished by an agreement between the trustee and the beneficiary. *Id.* § 242. It is only when such an agreement "*enlarg*[*es*] the trustee's compensation" that the agreement may be struck down as "unfair." *Id.* § 242 cmt. i (emphasis added). Where, as here, the fee is decreased, courts do not review it for fairness.

Petitioners suggest that mutual fund advisory fees are always extraordinary because "the adviser creates the fund" and does not engage in arm's-length bargaining over compensation at that time. See Pet'r Br. 36 & n.27 (citing Restatement (Second) of Trusts § 242 (providing that adviser is limited to "reasonable" fee when it "induce[s]" an excessive fee by "abus[ing] ... a fiduciary ... relationship"), and *Lederman* v. *Lisinksy*, 112 N.Y.S.2d 203, 205-06 (Sup. Ct. 1952) (reducing fees to statutory rate where trustee who drafted the instrument abused pre-existing fiduciary relationship as settlor's attorney)). But Petitioners overlook the subsequent arm's-length transaction between the fund and the shareholder, and the choice the shareholder has not to buy any shares in the fund. Provided that the fee rate is properly disclosed, as it was in this case and as it has to be under the ICA and other securities laws, see, *e.g.*, ICA

§ 34(b); 15 U.S.C. §§ 77g, 77j, the shareholder has no ground for subsequently objecting to the rate to which he freely agreed.[4]

Irrespective of the relationship between the adviser and the fund, the fee is ultimately the result of the shareholder's own investment decision.[5] If the ad-

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[4] Understandably, Petitioners do not contend that the particular fees that Respondent charged – which were never more than one percent and were consistent with fees across the mutual fund industry – were so extravagantly high as to be "extraordinary." Accordingly, the Court need not decide whether a particular fee could be so aberrational as to warrant judicial reduction despite full disclosure of the rate and voluntary acceptance by the shareholders in an arm's-length transaction. *Cf. Jones*, 527 F.3d at 632 (suggesting potential breach of fiduciary duty when "university's board of trustees decides to pay the president $50 million a year, when no other president of a comparable institution receives more than $2 million"); *Raleigh Banking & Trust Co.* v. *Leach*, 86 S.E. 701, 703 (N.C. 1915) (rejecting challenge to fee rate in deed of trust, but suggesting in *dictum* that a fee could be reduced if it is "so large as to be oppressive").

[5] Petitioners understandably do not invoke the "equitable deviation" standard. That equitable principle authorizes courts to alter trust agreements when (a) there is an unanticipated circumstance that prevents or frustrates the fulfillment of the trust's purpose, and (b) the alteration would substantially fulfill the trust's purpose. Restatement (Second) of Trusts § 167(1) (allowing modification to trust owing to change in circumstances). *But see id.* § 167 cmt. b ("The court will not permit or direct the trustee to deviate from the terms of the trust merely because such deviation would be more advantageous to the beneficiaries than a compliance with such direction."); *id.* § 167 cmt. c (authorizing modification to investments "only if[] the accomplishment of the purposes of the trust would otherwise be defeated or substantially impaired"). Petitioners do not allege any such unanticipated circumstance. Nor could they. The amount of the adviser's fees grew only because the funds were successful and grew in size, not because of any rate increase. Success and growth are not unanticipated circumstances that

viser sets its fee too high, the shareholder is free to reject it and to take his money elsewhere. The shareholder's independent decision serves as an arm's-length check on the size of the fee.

Unsurprisingly, Petitioners and their supporting *amici* fail to cite a single case holding that a trustee breaches its duty when it receives only the compensation that was properly established at arm's length, let alone when the compensation is subsequently decreased. And, Petitioners candidly acknowledge that, "[w]hen such arm's-length negotiating occurs between unrelated parties, some cases have enforced that bargain, even if the trustee's compensation appears high compared to what trustees typically receive for similar work." Pet'r Br. 35. The only authority that Petitioners and their *amici* cite for the contrary proposition is the Restatement (Third) of Trusts, the relevant volume of which was published in 2003. See *id.* at 35 n.26 (citing Restatement (Third) of Trusts § 38 cmt. e (2003)); Br. of Profs. Demott & Ascher 12-15 (same). Because the Third Restatement postdates Section 36(b) by more than three decades, and because it cites no case law for its newfangled and counter-intuitive position, it should not be deemed controlling of Congress's intent in enacting Section 36(b) in 1970. See, *e.g.*, *Carcieri* v. *Salazar*, 129 S. Ct. 1058, 1064 (2009) (looking to meaning of word "as understood when [the statute] was enacted"); *Director, Office of Workers' Comp. Programs* v. *Greenwich Collieries*, 512 U.S. 267, 275 (1994) (presuming Congress intended "the meaning generally accepted in the legal community at the time of enactment"); Br. of United States 17 (noting "that the Second Restate-

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frustrate a fund's mission; rather, they are the very purpose of the fund.

ment reflects the state of trust law at the time Congress enacted Section 36(b)").

3. Because a trustee does not breach a fiduciary duty when it merely accepts the arm's-length negotiated fee rate (or, as here, accepts a reduction in the fee schedule), Petitioners' remaining arguments are unavailing. First, Petitioners contend that it is unfair for the adviser to charge mutual funds more than what the advisor charges independent investors. Pet'r Br. 48-51. But, if Petitioners considered the fee rate too high, they should not have elected to invest their money with Respondent in the first place. Plaintiffs should not be allowed to buy into a lawsuit by purchasing shares in a fund, and then, after the fact, be heard to complain that the pre-existing, disclosed fees are too high compared to what other customers are paying.

Moreover, Congress did not require investment advisors to charge every investor the rates obtained by the best negotiator. It is not uncommon for a fiduciary to charge different rates to different clients. Indeed, Petitioners' own attorneys might follow the not-uncommon industry practice of charging different rates. Petitioners voluntarily accepted the fee rates that the investment adviser offered to them, and it is irrelevant whether the adviser charged other investors less.

In any event, the regulatory and commercial contexts of the two types of funds are fundamentally different. See Resp. Br. 39-44. Mutual funds must bear the costs and burdens of federal and state laws that do not apply to institutional funds. Also, large institutional funds typically have their own management structure and retain their own liquidity, requiring fewer services from and costs to investor advisers. See, *e.g.*, Rene Stulz, *Hedge Funds: Past, Present, and*

Future, 21 J. Econ. Perspectives 175 (2007); Joseph Golec & Laura Starks, *Performance Fee Contract Change and Mutual Fund Risk*, 73 J. Fin. Econ. 93 (2004). Any differential in apparent fee rates may simply be due to the different services provided. See, *e.g.*, *Jones*, 2007 WL 627640, at *1 (finding that Harris provided "more limited" services to institutional clients than to mutual fund clients); see also Coates & Hubbard, *supra*, at 184-88; *Gartenberg* v. *Merrill Lynch Asset Mgmt., Inc.*, 694 F.2d 923, 930 n.3 (2d Cir. 1982) ("The nature and extent of the services required by each type of fund differ sharply."). It is therefore inadequate for a plaintiff to allege different rates. Under this Court's recent decisions in *Ashcroft* v. *Iqbal*, 129 S. Ct. 1937 (2009), and *Bell Atlantic Corp.* v. *Twombly*, 550 U.S. 544 (2007), merely alleging a rate differential would not be sufficient to survive a motion to dismiss.

Second, Petitioners and their supporting *amici* argue that an adviser must share economies of scale, and thus have "breakpoints" that automatically reduce fee rates when the fund grows to a certain size. But, when an investor voluntarily buys shares in a fund without breakpoints, he cannot then object to the investment decision he made. Moreover, the presence of breakpoints is not necessarily better for shareholders, let alone more "fair."[6] Breakpoints simply mean that the fee rate declines as the fund

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[6] To take a basic example, an adviser may charge a flat rate of one percent, or he may charge a rate of 1.2 percent up to a breakpoint, and then 0.8 percent thereafter. If he negotiates for a flat rate, then the adviser bears more risk that the fund does not grow, and he reaps more upside if it does. By negotiating for the breakpoint, the adviser transfers both some risk and some reward to the shareholders. But neither option is intrinsically better for shareholders, or more fair than the other.

grows in size; they do not ensure that the initial fee rate is lower, nor do they guarantee that the effective fee rate, after all gradations are taken into account, will be lower than it would absent breakpoints.[7] In any event, all three of Respondent's funds in question had breakpoints, and those breakpoints were reduced in 2003 and 2004. Def's Br. in Support of Summ. J. 5-6.

Third, Petitioners contend that Respondent breached its fiduciary duty by failing to disclose material information. But Petitioners do not allege any failure to disclose the fee rates when Petitioners purchased their shares, and after that the rates never increased. Thus, Petitioners paid no more in fees than what they voluntarily agreed to pay, after full disclosure, when they purchased their shares. Petitioners knew the rates, and they bought the shares.

If Respondent failed to disclose material information in violation of ICA Sections 15(c) or 34(b), the SEC may be able to bring an enforcement action

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[7] Nothing in the legislative history requires advisers to accept breakpoints, even setting aside the inherent infirmities in relying on legislative history. Although the Senate Report indicates that "problems arise" due to economies of scale, the report does not determine that failure to share such economies is a *per se* breach of fiduciary duties. Senate Report, *supra*, at 4902. Rather, the report makes clear that "best industry practice will provide a guide," and that "[t]his section ... should not be taken as reflecting any finding by the committee that the present industry level of management fees or that the fee of any particular adviser is too high." *Id.* Moreover, as the SEC has recognized, advisers may share the benefits of economies of scale with investors in many ways other than by adopting breakpoints, including by reducing fees through voluntary waivers or contractual fee reductions or by providing additional services to the fund and fund shareholders. *Report on Mutual Fund Fees and Expenses*, *supra*.

under those provisions. But such non-disclosure would not render the fee rate – which the shareholder accepted in an arm's-length transaction – excessive and actionable under Section 36(b). The private remedy available under Section 36(b) relates only to excessive fees and does not bestow on the plaintiffs' bar broad authority to enforce all of the disclosure obligations under the ICA. This Court should reject Petitioners' attempt to imply a new cause of action by impermissibly expanding an existing one. See generally *Alexander* v. *Sandoval*, 532 U.S. 275, 286-88 (2001).

Finally, it is irrelevant that the shareholders and the board of directors can periodically review an adviser's compensation and seek to impose a different rate. *Contra* Pet'r Br. 36-37. Under the common law of trusts, beneficiaries can likewise renegotiate the trustee's rate, and the compensation may be enlarged or diminished by an agreement between the beneficiary and trustee. See Restatement (Second) of Trusts § 242. As noted above (*supra* p. 18), it is only when such an agreement "*enlarg*[*es*] the trustee's compensation" that the agreement may be struck down as "unfair." Restatement (Second) of Trusts § 242 cmt. i (emphasis added). Where, as here, the fiduciary reduces its fee schedule, the fiduciary does not breach its duty. The law of trusts – the only source on which Petitioners rely – undermines their claim.

II. EVEN IN CASES IN WHICH THE FEE RATE INCREASES, SECTION 36(b)(2) DOES NOT PERMIT JUDICIAL RATE REGULATION BUT INSTEAD CONTEMPLATES A SIGNIFICANT ROLE FOR INVESTMENT COMPANY DIRECTORS AND DEFERENCE TO THOSE DIRECTORS, IN LIGHT OF ALL THE RELEVANT CIRCUMSTANCES.

1. There is no need for the Court to address the merits of an excessive-fee claim raised in the context of a fee increase. As noted, Respondent did not increase the fees in any of the funds in question. However, if the Court chooses to address the merits of such a claim, the Court should reject the judicial rate regulation that Petitioners endorse. Under the ICA, directors – not courts – are assigned the "primary" role in determining compensation. As this Court has explained, "the structure and purpose of the ICA indicate that Congress entrusted to the independent directors of independent companies, exercising the authority granted to them by state law, the primary responsibility for looking after the interests of the fund's shareholders." *Burks*, 441 U.S. at 484-85.

The statute's text supports this construction. Under Sections 15 and 36(a), directors are invested with fiduciary duties, and board approval is required, *inter alia*, when establishing an adviser's compensation. Section 36(b) also provides that "approval by the board of directors ... shall be given such consideration by the court as is deemed appropriate under all the circumstances." ICA § 36(b)(2). And, the legislative history further confirms that Congress did not intend courts to substitute their business judgment for that of directors in setting fees. Senate Report, *supra*, at 4902 ("This section is not intended to authorize a court to substitute its business judgment for that of

the mutual fund's board of directors in the area of management fees.").

2. Judicial rate regulation is especially inappropriate insofar as a mutual fund is subject to competition, which would serve as an external check on excessive fees. See, *e.g.*, *Matsushita Elec. Indus. Co.* v. *Zenith Radio Corp.*, 475 U.S. 574, 591 (1986) ("[W]ithout barriers to entry it would presumably be impossible to maintain supracompetitive prices for an extended period of time."). As explained above, *supra* pp. 4-7, the mutual fund industry has experienced extraordinary growth, reflecting the absence of barriers to entry. During the same period, there has been a steady decline in fee rates, consistent with an increase in competition. *Id.* Accordingly, a failure by a board of directors to hold advisory fees in check would be counter-productive, and the fund would be short-lived. Prospective investors would be less likely to purchase shares in funds with excessive fees, and current investors in such funds could redeem their shares and move their proceeds to alternative investments.

The Court need not make any broad pronouncement regarding the state of the industry. As the Solicitor General suggests, the Court could permit a "case-specific" approach to assessing the level of competition. See Br. of United States 28. But, at the very least, because of the dramatic growth in the industry, and because plaintiffs bear the burden of proof under Section 36(b), competition should at least be presumed.

3. In any event, even if competition were lacking, courts should not rigorously regulate advisory fee rates. Instead, courts should apply a deferential approach that recognizes the directors' "primary" role in managing the fund and determining advisory fees,

Burks, 441 U.S. at 484-85, and the investors' ability to walk away from a mutual fund by redeeming their shares upon demand, and to refuse to invest in a particular fund in the first instance. This is essentially what courts have been doing for decades. See, *e.g.*, *Gartenberg*, 694 F.2d at 928 (examining whether an adviser "charge[s] a fee that is so disproportionately large that it bears no reasonable relationship to the services rendered and could not have been the product of arm's-length bargaining"). And this approach would also serve the interest of judicial economy by leaving to the SEC – which has expertise and experience in these matters – the primary responsibility to regulate funds under the ICA.

As part of this analysis, courts should examine whether the board complied with the ICA's statutory procedures. See, *e.g.*, ICA § 15. Also relevant to any judicial review is the independence and conscientiousness of the directors. This board-centered approach is consistent with the statute's text, which requires courts to apply a level of deference to board decisions that is appropriate under "all the circumstances." *Id.* § 36(b)(2); see also H.R. Rep. No. 91-1382, at 37 (degree of deference depends on "whether the deliberations of the directors were a matter of substance or a mere formality"); Senate Report, *supra*, at 4903 ("[A] responsible determination regarding the management fee by the directors including a majority of disinterested directors is not to be ignored.").

Comparisons to other funds can also provide courts with a useful benchmark for assessing whether the board's decision was a responsible one worthy of deference. But it is essential to compare only similarly situated funds that compete with each other for the same investment dollars. As explained above, the

fees charged to institutional investors – whose investments are governed by a different regulatory scheme and require different services – shed no light on what is a lawful fee for a mutual fund. See *supra* pp. 20-21; see also Resp. Br. 39-44; *Gartenberg*, 694 F.2d at 930 n.3; Stulz, *supra*, at 175; Golec & Starks, *supra*, at 93; Coates & Hubbard, *supra*, at 184-88.

CONCLUSION

For the foregoing reasons, the decision of the court below should be affirmed.

Respectfully submitted,

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August 27, 2009

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